

CHILE – TAXES ON ALCOHOLIC BEVERAGES

Report of the Panel

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I. PROCEDURAL BACKGROUND

1.1 This proceeding has been initiated by a complaining party, the European Communities.

1.2 On 4 June 1997, the European Communities requested consultations with Chile under Article XXII:1 of the General Agreement on Tariffs and Trade 1994 ("GATT 1994") and Article 4 of the Understanding on Rules and Procedures Governing the Settlement of Disputes ("DSU") with regard to the Special Sales Tax on Spirits of Chile (WT/DS87/1). Chile agreed to the request. Peru, the United States, and Mexico requested, in communications dated 19 June 1997 (WT/DS87/2), 23 June 1997 (WT/DS87/3) and 20 June 1997 (WT/DS87/4) respectively, to be joined in those consultations, pursuant to Article 4.11 of the DSU. Consultations between the European Communities and Chile were held on 3 July 1997, in which Peru, the United States and Mexico participated, but the parties were unable to settle the dispute.

1.3 On 3 October 1997, the European Communities requested the establishment of a panel pursuant to Article 6 of the DSU (WT/DS87/5).

1.4 In its panel request, the European Communities claims that:

Chile, by according a preferential tax treatment, through the Special Sales Tax on Spirits, to pisco *vis-à-vis* certain alcoholic beverages falling within HS heading 2208, has acted inconsistently with Article III:2 of GATT 1994, therefore nullifying or impairing the benefits accruing to the European Communities under GATT 1994.

1.5 The Dispute Settlement Body (DSB) agreed to this request for a panel at its meeting of 18 November 1997, establishing a panel pursuant to Article 6 of the DSU with standard terms of reference.

1.6 Canada, Mexico, Peru and the United States reserved their rights to participate in the Panel proceedings as third-parties.

1.7 On 15 December 1997, the European Communities further requested consultations with Chile under Article XXII:1 of GATT 1994 and Article 4 of the DSU with regard to the Additional Tax on Alcoholic Beverages ("Impuesto Adicional a las Behidas Alcoholicas"), as modified by Law No. 19,534 (WT/DS110/1). The United States and Mexico requested, in communications dated 23 December 1997 (WT/DS110/2) and 27 December 1997 (WT/DS110/3) respectively, to be joined in those consultations, pursuant to Article 4.11 of the DSU. Also, on 16 December 1997, the United States requested consultations with Chile under Article XXII of GATT 1994 and Article 4 of the DSU (WT/DS109/1). Peru and Mexico requested, in communications dated 17 December 1997 (WT/DS109/2) and 27 January 1998 (WT/DS109/3) respectively, to be joined in those consultations, pursuant to Article 4.11 of the DSU. Joint consultations between the European Communities and the United States, the requesting parties, and Chile, were held on 28 January 1998, in which Peru and Mexico participated, but the parties were unable to settle the dispute.

1.8 On 9 March 1998, the European Communities requested the establishment of a panel pursuant to Article 6 of the DSU (WT/DS110/4).

1.9 In its panel request, the European Communities claims that:

Like the measures which are subject of the Panel established on 18 November 1997, the modifications introduced by Law No. 19.534, including those to be applied on a transitional basis until 1 December 2000, are inconsistent with Chile's obligations under the GATT. In particular, the modifications introduced by Law No. 19.534

impose a lower tax rate on domestic pisco than on certain other like distilled spirits and liqueurs imported from the European Communities, thus infringing GATT Article III:2, first sentence. Those modifications also impose a lower tax rate on domestic pisco than on certain other directly competitive or substitutable distilled spirits and liqueurs imported from the European Communities so as to afford protection to Chile's domestic production, thereby violating GATT Article III:2, second sentence.

1.10 The DSB agreed to this request for a panel at its meeting of 25 March 1998, establishing a panel pursuant to Article 6 of the DSU with standard terms of reference. At this meeting, the DSB further agreed, pursuant to Article 9 of DSU, that the Panel established at the DSB meeting of 18 November 1997, should also examine the complaint of the European Communities in WT/DS110/4.

1.11 The Panel has the following standard terms of reference:

To examine, in the light of the relevant provisions of the covered agreements cited by the European Communities in documents WT/DS87/5 and WT/DS110/4, the matter referred to the DSB by the European Communities in those documents and to make such findings as will assist the DSB in making the recommendations or in giving the rulings provided for in those agreements.

1.12 Canada, Mexico, Peru and the United States reserved their rights to participate in the Panel proceedings as third-parties.

1.13 On 10 and 11 June 1998, the European Communities and Chile, respectively, requested the Director-General, pursuant to Article 8.7 of the DSU, to determine the composition of the Panel. On 1 July 1998, the Chairman of the DSB informed the parties that the Director-General composed the Panel as follows:

Chairman: Mr. Wilhelm Meier

Members: Mr. Mohan Kumar

Professor Colin McCarthy

1.14 The Panel had substantive meetings with the parties on 6 and 7 October 1998, and on 11 November 1998.

II. FACTUAL ASPECTS

A. MEASURES IN ISSUE

1. Transitional System

2.1 The measure at issue is the so-called "Additional Tax on Alcoholic Beverages" ("*Impuesto Adicional a las bebidas Alcohólicas*", hereafter "ILA"), contained in Law No. 19,534.¹

¹ Law No. 19,534 of 13 November 1997, amending Article 42 of Decree Law 825/74 (hereafter, "Law 19,534/97") (EC Exhibit 3). The European Communities claims that the measure in issue is contained in Decree-Law No. 825, of 27 December 1974, on the Tax on Sales and Services (hereafter, "Decree-Law 825/74" (EC Exhibit 4), amended by Law No. 19,534. The text of this Decree-Law was replaced by Decree-Law No. 1606, of 30 November 1976 ("hereafter", Decree-Law 1606/76) (EC Exhibit 6). In contrast, Chile claims that

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

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

2.4 The Old Chilean System distinguished three types of distilled spirits ("pisco", "whisky" and "other spirits", a residual category comprising all distilled spirits other than pisco and whisky) and applied to each of them a different *ad valorem* tax rate.² The Transitional System also applies different rates of taxes depending on whether the product is considered "pisco", "whisky" or "other spirits," until 1 December 2000. Nevertheless, as a transitional measure, it provides for a progressive reduction of the rate on whisky in accordance with the schedule shown in Table 1 below, while applies the same rate to pisco as the Old Chilean System until the new tax system takes effect on 1 December 2000.^{3,4}

Table 1

Applicable tax rates from 1 December 1997 to 1 December 2000

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

*Old Chilean System

2. New Chilean System

2.5 The new tax system introduced by Law 19,534 (hereafter referred to as the "New Chilean System") abolishes the distinction between pisco, whisky and "other spirits". Instead, all distilled spirits are taxed according to a scale based on their degree of alcohol content.⁵

2.6 Law 19,534 provides that, as shown in Table 2 below, all spirits with an alcohol content of 35° or less are taxed at the rate of 27 %. From that base, the rate escalates in increments of 4

Law No. 19,534 constitutes an entirely new law, repealing and replacing Decree-Law 825/74. The Panel considers that there is no substantive difference between the two positions.

² Article 42 of Decree 825/74, as lastly amended by Article 4.III of Law No. 18,413, of 8 May 1985 (hereafter, "Law 18,143/85") (EC Exhibit 11).

³ Transitional Article of Law 19,534/97 (EC Exhibit 3).

⁴ EC First Submission, Table 4.

⁵ Single Article of Law 19,534/97 (EC Exhibit 3).

percentage points per additional degree of alcohol, peaking at a rate of 47 % for all spirits bottled over 39°.

Table 2⁶

Tax rates applicable from 1 December 2000

<u>Alcohol content</u>	<u>Tax rate <i>ad valorem</i></u>
Less or equal to 35°	27 %
Less or equal to 36°	31 %
Less or equal to 37°	35 %
Less or equal to 38°	39 %
Less or equal to 39°	43 %
Over 39°	47 %

B. PRODUCTS IN ISSUE

2.7 The products in issue in this dispute are all distilled spirits falling within the heading 22.08 of the Harmonised System ("HS") nomenclature, including, but not limited to the following:

- all kinds of pisco falling within HS 2208;
- all kinds of whisk(e)y falling within HS 2208.30 (hereafter, "whisky");
- all kinds of brandy obtained by distilling grape wine or grape marc and falling within HS 2208.20 (hereafter, "brandy");
- all kinds of rum and taffia falling within HS 2208.40 (hereafter, "rum");
- all kinds of gin and geneva falling within HS 2208.50 (hereafter, "gin");
- all kinds of vodka falling within HS 2208.60 (hereafter, "vodka");
- all kinds of liqueurs falling within HS 2208.70, such as anisettes, curacao, cream liqueurs, emulsions and bitters (hereafter, "liqueurs"); and
- all kinds of aquavit, korn, fruit brandies (such as plum brandy, cherry brandy, pear brandy and cider brandy), ouzo and tequila falling within HS 2208.90 (hereafter, "aquavit", "korn", "fruit brandies", "ouzo" and "tequila", respectively).

1. Pisco

2.8 Under Chilean law, the term "pisco" is a protected geographical indication, the use of which is reserved exclusively for wine distillates produced and bottled in certain regions of Chile from certain varieties of muscat grapes grown in those regions.⁷

⁶ EC First Submission, Table 5.

⁷ The European Communities points out that according to the explanations provided by Chile during the consultations, the protected geographical indication for pisco was "made official" in 1931 by means of Decree-Law 181. *See* Chile's answers to questions from the EC dated 22 July 1997 (EC Exhibit 1).

2.9 Article 28 (a) of Law No. 18,455/85⁸ provides that the designation "pisco":

[...] is reserved for *aguardiente* produced and bottled, in units for consumption, in the regions III and IV, made by distillation of genuine potable wine obtained from the varieties of grapevines to be determined by regulation, planted in the said regions.

2.10 The term *aguardiente*, in turn, is defined in Decree 78/1986⁹ (which implements Law No. 18,455/85) as follows:

A distillate of wine, to which no additives have been added except sugar and water.¹⁰

2.11 Decree 78/1986 also specifies that pisco may be produced only from wine obtained from one or more of the following varieties of grapes of the species *Vitis Vinifera L*: *Chasselas Musque Vrai*, *Moscatel Amarilla*, *Moscatel Blanca Temprana*, *Moscatel de Alejandría* or *Italia*, *Moscatel de Austria*, *Moscatel de Frontignan*, *Moscatel de Hamburgo*, *Moscatel Negra*, *Moscatel Rosada* or *Pastilla*, *Moscato de Canelli*, *Muscat Orange*, *Pedro Jiménez* and *Torontel*.¹¹ In practice, most pisco is made by blending spirits distilled from two or more of these types of grapes.

2.12 The so-called *zona pisquera* currently comprises Regions III (Atacama) and IV (Coquimbo). These two regions lay between the parallels 27 and 32, some 600 kilometres north of Santiago, and are characterised by a very dry and sunny climate. The grapes for the production of pisco are grown along a series of narrow valleys irrigated by rivers flowing from the Andes into the Pacific, the so-called five *valles pisqueros*: Copiapó, Vallenar, Elqui, Limarí and Choapa.

2.13 The production of pisco is dominated by two large co-operatives, each grouping several hundred associated grape growers: Cooperativa Agrícola Pisquera Elqui Ltda (hereafter "Capel") and Cooperativa Agrícola Control Pisquero de Elqui y Limarí (hereafter "Control"). It is estimated that, together, Control and Capel account for more than 90 % of the sales of pisco.

2.14 The main stages in the production process of pisco may be summarised as follows:

- (i) harvesting and grinding of the grapes;
- (ii) fermentation of the grape-juice in large earthenware or steel containers in order to produce wine, with an alcohol strength of approximately 14°;
- (iii) distillation of the wine in copper pot stills.¹² The raw spirit obtained at the end of this phase has about 55°-60°;
- (iv) maturation of the raw spirit in wooden containers for a relatively short period of time, usually not exceeding several months. The best quality brands may be stored in American oak casks for a longer period; and

⁸ Law No. 18,455, of 31 October 1985, laying down rules for the production, preparation and marketing of ethyl alcohol, alcoholic beverages and vinegar (hereafter, "Law 18,455/85") (EC Exhibit 12).

⁹ Decree No. 78 of 31 July 1986 implementing Law 18,455/85 (hereafter, "Decree 78/1986") (EC Exhibit 13).

¹⁰ *Ibid.*, Article 1.2.

¹¹ *Ibid.*, Article 56.

¹² According to the European Communities, the stills are similar to those used by the producers of Cognac. The distillation process may be described as a "batch" process, rather than a continuous process, although rectifiers are sometimes used to boost the strength of the spirit.

- (v) finally, the spirit from the different distilleries is centralised to be blended, diluted with de-mineralised water in order to obtain the desired alcohol strength, filtered and bottled.

2.15 By law, pisco must have an alcohol content of no less than 30°; the four types of pisco are designated as¹³:

- | | | |
|---|--|----------------------|
| – | <i>Pisco corriente</i> or <i>tradicional</i> | between 30° and 35°; |
| – | <i>Pisco especial</i> | between 35° and 40°; |
| – | <i>Pisco reservado</i> | between 40° and 43°; |
| – | <i>Gran pisco</i> | 43° or more. |

2.16 According to the explanations provided by the Chile during the consultations, Chile's pisco industry is currently producing and selling pisco of the following alcohol contents¹⁴:

- | | | |
|---|--|-------------------|
| – | <i>Pisco corriente</i> or <i>tradicional</i> | 30°, 32°, 33° |
| – | <i>Pisco especial</i> | 35° ¹⁵ |
| – | <i>Pisco reservado</i> | 40° |
| – | <i>Gran pisco</i> | 43°, 46° and 50° |

2.17 According to the regulations in force, the four different types of pisco are distinguished solely in terms of their alcohol strength.¹⁶ As already indicated by its name, *pisco tradicional* or *corriente* used to be the largest selling type of pisco. Over the last few years, however, it has been overtaken by *pisco especial*, which is now the best selling pisco category. *Pisco reservado* and *gran pisco* account for about 9 % of the market.

2.18 Although there are no official statistics on the production or sale of the different types of pisco, the European Communities submitted market data compiled by AC Nielsen, a private market organization employed by the European distilled spirits industry to estimate the market share of each type of pisco, as follows:¹⁷

¹³ Decree 78/1986, Article 56.

¹⁴ Chile's answers to questions from the EC dated 24 February 1998 (EC Exhibit 2).

¹⁵ According to the European Communities, the brand "Control de Guarda" appears to be sold also at 36°. See EC Exhibit 51.

¹⁶ Article 13 of Decree 78/1986 (EC Exhibit 13).

¹⁷ The European Communities submits the source of Table 4 as EC Exhibit 24.

Table 3¹⁸

Pisco sales by category

	<u>Aug 94/July95</u>	<u>Aug 95/July96</u>	<u>Aug96/July97</u>
<i>Tradicional</i>	46.2 %	35.8 %	34.5 %
<i>Especial</i>	40.8 %	49.8 %	51.4 %
<i>Reservado</i>	5.5 %	6.4 %	6.3 %
<i>Gran Pisco</i>	4.4 %	4.8 %	4.2 %
<i>Pisco sour</i> ¹⁹	3.0 %	3.2 %	3.7 %

Basis: % of total sales of pisco

2.19 Chile provides information concerning production and sales of various types of distilled spirits in Chile. Table 4 indicates the data for 1997.²⁰

¹⁸ EC First Submission, Table 1.

¹⁹ The European Communities notes that *pisco sour* is not a variety of pisco but, rather, a cocktail made with pisco. Specifically, Decree 78/1986 (Article 58) defines *pisco sour* as "[...] the cocktail produced and bottled in regions III and IV, prepared with pisco, lemon juice or natural lemon flavouring [...]". Table 3 shows the share of pre-mixed *pisco sour*.

²⁰ Chile First Submission, Annex III, Table 7. Chile additionally provides the following estimates by the domestic industry of pisco production in 1998 (January to September): Pisco 30° - 8,613.0, Pisco 35° - 20,730.0; Pisco 40° to 46° - 2,465.0; Aguardiente min. 30° - 45.0; and Aguardiente min. 50° - 480.0 (million litre).

Table 4

Volume in Thousands Litres and Value in Thousands of US\$

Type of Spirits	Production 1997		Imports 1997		Exports 1997		Apparent Consumption 1997	
	Volume	Value	Volume	Value	Volume	Value	Volume	Value
Total, Pisco of different alcoholic content*	40,977.9		0.0	0.0	301.6	933.3	40,676.3	
Pisco 30° *	16,276.5							
Pisco 35° *	20,969.0							
Pisco 40° - 46° *	3,732.5							
Aguardiente minimum 30°			9.1	37.9				
Aguardiente minimum 50°								
Other grape spirits			94.4	336.2	106.1	266.0		
Brandy, cognac, armagnac (minimum 38°)								
Grapa (minimum 30°)								
Whisky (minimum 40°)			2,484.7	13,799.7	0.2	3.6		
Rum and other spirits of sugar cane (minimum 40°)			642.8	1640.8	0.3	1.6		
Gin and geneva (minimum 40°)			198.9	967.8	0.0	0.0		
Other Spirits			1,679.9	6,412.9	111.3	287.2		
<u>Vodka (minimum 40°)</u>			<u>389.9</u>	<u>1,246.4</u>	<u>0.0</u>	<u>0.1</u>		
Liqueurs			183.1	1,359.6	41.7	71.8		
Other spirits			1,106.9	3,806.9	69.6	215.3		

Sources:

(1) Production:

- Piscos according to alcoholic strength: Control Pisquero Ltd. and Capel Ltd.
- Aguardiente; Brandy, Cognac, Armagnac; grapa; whisky; rum and other spirits of sugar cane; gin and geneva; vodka; other distilled spirits; fruit liqueurs; anisette, anise liqueur; arack, pastis, anesone; bitter liqueurs; cocktails; other spirits: **Asociación de Licoristas de Chile.**

(2) Exports and Imports: Central Bank of Chile.

Notes: (i) Bold type represents the sum, where possible, of the rows below.

(ii) The row vodka (minimum 40°) is underlined for emphasis, since there are import and export statistics for the years 1996 and 1997.

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

2. The Other Spirits in Issue

2.21 The names of the main types of distilled spirits at issue in this dispute, other than pisco, are permitted to be used only for those alcoholic beverages which are defined by Decree 78/1986 in the following terms²¹:

²¹ According to the European Communities, Decree 78/1986 contains no definition of rum.

- (i) Whisky: "The distillate of the alcoholic fermentation of malted or unmalted mashes of grain, which is subjected to ageing processes in wooden vessels, whether or not coloured with natural caramel".²²
- (ii) Brandy: "*Aguardiente* aged in vessels of noble wood, whether or not coloured with natural caramel, and whether or not sweetened with sugar".²³
- (iii) Gin: "Beverage obtained by flavouring rectified alcohol from starchy raw materials with distillates, macerations or essential oils from juniper berries".²⁴
- (iv) Vodka: "Beverage obtained from alcohol from starchy raw materials, with or without maceration of grass".²⁵
- (v) Liqueurs: "The product prepared from potable ethyl alcohols, distillates, fermented alcoholic beverages, whether or not mixed with each other, and with or without natural or synthetic aromatic extracts. It may contain sweeteners, water, colorants or any other permitted additive".²⁶

2.22 Decree 78/1986 also prescribes the minimum alcohol content requirements for the use of the main type names of distilled spirits in dispute, as follows²⁷:

Table 5²⁸

Legally required minimum alcohol strength in Chile

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

²² Decree 78/1986, Article 1.42 (EC Exhibit 13).

²³ *Ibid.*, Article 1.5.

²⁴ *Ibid.*, Article 1.11.

²⁵ *Ibid.*, Article 1.41.

²⁶ *Ibid.*, Article 1.17.

²⁷ *Ibid.*, Article 12.

²⁸ EC First Submission, Table 2, with corrections made by the Panel based upon Decree 78/1986, Article 18 (EC Exhibit 13)..

C. HISTORY OF TAXATION OF ALCOHOLIC BEVERAGES IN CHILE

2.23 Between 1916 and 1954, pisco was totally exempted from the excise taxes imposed on the other alcoholic beverages. Between 1954 and 1974, pisco was taxed at a rate that was half of the rate applied to all the other liquors.

2.24 In 1974, Decree-Law No 826/74 introduced a 40 % *ad valorem* tax on all categories of spirits, including pisco.²⁹ At the same time, however, Decree-Law 826/74 imposed a 50 % surcharge ("*recargo*") on all imported beverages.³⁰

2.25 In 1977, Decree-Law 826/74 was amended by Decree-Law 2,057/77, which abolished the *recargo*.³¹ Simultaneously Decree-Law 2,057/77 lowered the rate of tax on pisco from 40 % to 25 %, while the tax on other spirits was reduced from 40 % to 30 %.

2.26 In June 1979, Decree-Law No 826/74 was repealed and replaced by the ILA, a new tax applied in conjunction with the Value Added Tax system.³² At first, the ILA was applied at the same rates as the tax which it had replaced, i.e., 25 % on pisco and 30 % on all other distilled spirits.³³ But in December 1983 the rate on distilled spirits other than pisco was increased from 30 % to 50 %, while the rate applied to pisco was unchanged at 25 %.³⁴

2.27 On 23 January 1984, the ILA was amended again in order to lower the applicable rate on distilled spirits other than pisco and whisky from 50 % back to its previous level of 30 %.³⁵ At the same time, the rate on whisky was further increased from 50 % to 55 %.³⁶ Thus, following these changes, the ILA was applied at three different rates: 25 % on pisco; 55 % on whisky and 30 % on all other distilled spirits.

2.28 In May 1985, the rate on whisky was increased once again from 55 % to 70 %.³⁷ Following this change, the ILA rates have remained unmodified until the amendment approved in November 1997.

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

²⁹ Article 3 of Decree-Law No. 826, of 27 December 1974 (hereafter, "Decree 826/74") (EC Exhibit 5).

³⁰ *Ibid.*

³¹ Decree-Law No. 2,057 of 30 November 1977 amending Decree-Law 826/74 (hereafter "Decree 2,057/77") (EC Exhibit 7), Article 1.2.

³² Decree No 2,752, of 21 June 1979, integrating the taxes on alcoholic beverages within the VAT system (hereafter, "Decree 2,752/79") (EC Exhibit 8). According to the European Communities, this Decree-Law brought the taxation of alcoholic beverages within the scope of Decree-Law 825/74.

³³ *Ibid.*, Article 1.3.

³⁴ Article 4.III of Law No. 18,267, of 1 December 1983 amending Article 42 of Decree 825/74 (hereafter, "Law 18,267/83") (EC Exhibit 9).

³⁵ Article 1 of Law No. 18,289, of 23 January 1984 amending Article 42 of Decree 825/74 (hereafter, "Law 18,289/84") (EC Exhibit 10).

³⁶ *Ibid.*

³⁷ Article 4.III of Law 18,413/85 (EC Exhibit 11).

Table 6³⁸

Evolution of taxes rates between 1974 and 1997

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

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

III. CLAIMS OF THE PARTIES

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

3.2 The European Communities claims that³⁹:

- (i) the Transitional System, which is applicable through 30 November 2000, is contrary to GATT Article III:2, second sentence, because it provides for the imposition of lower internal taxes on pisco than on other directly competitive or substitutable imported spirits which fall within the tax categories of "whisky" and "other spirits", so as to afford protection to Chile's domestic production;
- (ii) the New Chilean System, which will become applicable as of 1 December 2000, is also contrary to Article III:2, second sentence, because it results in the imposition of lower taxes on pisco with an alcohol content of 35° or less than on other directly competitive or substitutable imported spirits which have a higher alcohol content, so as to afford protection to Chile's domestic production.⁴⁰

3.3 **In response, Chile contends** that the New Chilean System is fully consistent with Article III:2 because it taxes all distilled spirits, regardless of type and regardless of whether imported or domestic, according to identical objective criteria of alcoholic strength and value (*ad valorem*).

³⁸ EC First Submission, Table 7.

³⁹ The European Communities notes that in its panel request, it also claimed a violation of GATT Article III:2, first sentence. The European Communities states that even though certain spirits exported from the European Communities to Chile (including in particular certain types of brandy) may be considered as being "like" to pisco, it decided not to pursue that claim, given that those spirits are in any event "directly competitive or substitutable" with pisco.

⁴⁰ The European Communities argues that the New Chilean System already constitutes mandatory legislation, and as such, it may be the subject of dispute settlement under the WTO Agreement, citing Panel Report on *United States – Taxes on Petroleum and Certain Imported Substances*, BISD 34S/136, paras. 5.2.1-5.2.2.

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

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

IV. ARGUMENTS OF THE PARTIES

A. OVERVIEW

1. GATT Article III:2, second sentence

4.1 **The European Communities puts forth** the relevant GATT provision, GATT Article III:2, second sentence, which reads as follows:

Moreover, no Member shall otherwise apply internal taxes or other internal charges to imported or domestic products in a manner contrary to the principles set forth in paragraph 1.

4.2 Further, the European Communities refers to Article III:1, which provides in relevant part that:

The Members recognize that internal taxes ... should not be applied to imported or domestic products so as to afford protection to domestic production.

4.3 The European Communities then indicates that the Interpretative Note to Article III:2 states that:

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

4.4 The European Communities further points out that in *Japan - Taxes on Alcoholic Beverages II*⁴¹, the Appellate Body clarified that in order to determine whether an internal tax measure is inconsistent with Article III:2, second sentence, it is necessary to address the following three issues:

- (i) whether the imported products and the domestic products are "directly competitive or substitutable products" which are in competition with each other;
- (ii) whether the directly competitive or substitutable imported and domestic products are "not similarly taxed"; and

⁴¹ Appellate Body Report on *Japan - Taxes on Alcoholic Beverages* (hereafter, "*Japan - Taxes on Alcoholic Beverages II*"), adopted on 1 November 1996, WT/DS8/AB/R, WT/DS10/AB/R, WT/DS11/AB/R, p. 24. See also the Appellate Body Report on *Canada - Certain measures concerning Periodicals* (hereafter "*Canada - Periodicals*"), adopted on 30 June 1997, WT/DS31/AB/R, pp. 24-25.

- (iii) whether the dissimilar taxation of the directly competitive or substitutable imported products is "applied ... so as to afford protection to domestic production".

4.5 In addition, the European Communities points out that as a preliminary matter it must be ascertained whether the measures at issue are "internal taxes". The ILA is levied on all distilled spirits intended for consumption in Chile, whether locally manufactured or imported, and not just "on" or "in connection" with the importation of distilled spirits. Accordingly, the ILA constitutes an "internal tax" in the sense of GATT Article III:2, and not an "import charge" within the purview of GATT Articles II and VIII.

4.6 **Chile**, while agreeing that the proper basis for analyzing whether a measure conforms with Article III:2, second sentence, is the test set out in the ruling of the Appellate Body in *Japan - Taxes on Alcoholic Beverages II*, **points out** that concerning these three elements, the Appellate Body in *Japan - Taxes on Alcoholic Beverages II* emphasized that:

[T]hese are three *separate issues*. Each must be established separately by the complainant for a panel to find that a tax measure imposed by a Member of the WTO is inconsistent with Article III:2, second sentence.⁴²

4.7 Chile then argues that the EC complaint does not and could not meet this three-part test. Chile asserts that the European Communities, perhaps out of habit based on arguing about the Japanese and Korean tax systems, devotes the largest part of its argumentation to the first part of the three-part test: the question of whether pisco is directly competitive or substitutable with other spirits in the Chilean market. Chile does not agree that the European Communities has met its burden with respect to the first element. However, the issue of directly competitive or substitutable, which was at the core of the disputes concerning the Japanese and Korean systems of taxation, is essentially irrelevant in the analysis of the New Chilean System, because the new system eliminates all distinctions based on type of distilled spirits. Instead, the New Chilean System applies an identical system of taxation to all types of distilled spirits, regardless of whether they are like, competitive or substitutable and regardless of origin.

4.8 In response, **the European Communities contends** that Chile's strategy in this case is to divert the Panel's attention from the examination of Chile's own tax system. Chile attempts to do so by focusing the discussion on other tax systems (both real and hypothetical), which are fundamentally different from the New Chilean System. With the same purpose, Chile tries to focus the debate on a number of superficial differences between this case and previous cases.

4.9 According to the European Communities, Chile has good reasons to follow this strategy. Indeed, the New Chilean System does not withstand a close examination in light of the three-prong test established by the Appellate Body in *Japan - Taxes on Alcoholic Beverages II*.

2. Transitional System

4.10 With respect to the Transitional System, **the European Communities states** that from 1985 to November 1997 pisco was taxed at the rate of 25 % *ad valorem*, whereas whisky, the main imported distilled spirit, was taxed at the rate of 70 % and "other spirits" (a residual category comprising all distilled spirits other than pisco and whisky) at the rate of 30 %.

4.11 The European Communities argues that in an attempt to address longstanding complaints from the European Communities and other WTO Members, Chile amended its liquor tax system in

⁴² Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II*, *supra.*, p. 24 (emphasis added by Chile).

November 1997, following protracted discussions between its Government and the local pisco industry and a lengthy debate by the Chilean Congress.

4.12 According to the European Communities, the New Chilean System approved in November 1997 will not take effect until 1 December 2000. In the meantime, the previous system will remain in place, with the only difference that the tax rate on whisky will be progressively lowered from 70 % to 53 %.

4.13 The European Communities argues that the Transitional System, which is applicable until 30 November 2000, is contrary to GATT Article III:2, second sentence, because it provides for the imposition of lower internal taxes on pisco than on directly competitive or substitutable imported spirits that fall within the tax categories of "whisky" or "other spirits", so as to afford protection to Chile's domestic production.

4.14 **Chile replies** that the EC complaint about the Transitional System, in effect, seeks to replicate previous EC complaints about Japanese and Korean systems of alcohol taxation. Chile notes that by invoking the analysis of the Appellate Body in *Japan - Taxes on Alcoholic Beverages II*, the European Communities argues, among other things, that in Chile all distilled spirits are directly competitive or substitutable.

4.15 Chile goes on to state that, with respect to the Transitional System, it believes that there are significant differences of fact and law between this case and the cases of the Japanese and Korean systems that were found inconsistent with Article III:2. While all three systems make distinctions based on type of distilled spirit, there is much less difference in taxation under the Transitional System, and there are much stronger bases for considering that pisco is not competitive or substitutable in the Chilean market with any other type of spirit.

3. New Chilean System

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

4.17 The European Communities asserts that the New Chilean System abolishes only as a formal matter the distinction between pisco and the other types of distilled spirits. Instead, the applicable rate varies according to (but not proportionally with) alcohol content. Specifically, all spirits with 35° of alcohol content or less are taxed at the rate of 27 % *ad valorem*. From that base, the rate escalates by 4 percentage points for each additional degree of alcohol content, peaking at 47 % for all distilled spirits above 39°. Thus, for a mere five degrees increase in alcohol content, the applicable rate nearly doubles. In contrast, similar differences in alcohol content, both above and below the 35°-39° bracket, do not entail any difference in taxation at all.

4.18 The European Communities thus concludes that the New Chilean System is designed to continue to afford protection to pisco at the expense of imported distilled spirits. In fact, approximately 90 % of pisco is bottled at 30° to 35° and, therefore, will be taxed at the lowest rate of 27 %.

4.19 The European Communities further argues that in contrast, all imports of whisky, rum, gin, vodka and tequila (which together account for more than 95 % of all imports of spirits into Chile) will be taxed at the highest rate of 47 %. Furthermore, unlike pisco those spirits do not have the flexibility

to move down the scale. Under Chilean law, all of them must be bottled at no less than 40° and, therefore, are automatically locked in the highest rate of 47 %.

4.20 According to the European Communities, the protective effects of the New Chilean System are by no means incidental. The lack of internal coherence of the new system (as revealed in particular by the spasmodic progression of the tax rates) evidences that the tax differentials serve no legitimate purpose. Alcohol content has been chosen as a taxation principle simply because it provides a basis for replicating indirectly the protective effects of the old system, and not because the new system is genuinely aimed at discouraging alcohol consumption.

4.21 **Chile replies** that the New Chilean System, in terms of Article III:2, "similarly taxes" all distilled spirits, regardless of type. All distilled spirits are taxed according to the objective, neutral criteria of alcohol strength and value (*ad valorem*). The European Communities notes that low alcohol pisco will bear less tax than high alcohol scotch whisky, but that effect of the Chilean system is no more inconsistent with Article III:2 than is the higher tax that high horsepower U.S.-built cars may face in Europe relative to small European cars.

4.22 Chile contends that a violation of Article III has not occurred merely because, by some measurements, an imported product bears a higher tax than even a like domestic product, if the difference in the tax is not based on nationality of the product and results from the application of objective criteria. As will be demonstrated below, the European Communities itself has conceded in past WTO cases that neutral, objective criteria such as value (*ad valorem*) and alcohol content are permissible bases for a neutral tax system.

4.23 Chile points out that implicitly, the European Communities also concedes the legitimacy of an alcohol content system in this case as well, but the European Communities still tries to argue that the Panel should require still more: that the differentiation in *ad valorem* tax be directly and evenly proportional to the differences in alcohol content. There is no such requirement in the language or history of Article III:2.

4.24 According to Chile, while the European Communities tries to give the impression that this is just one more complaint about taxation of alcoholic beverages in the mold of recent cases such as those involving Japan (twice) and Korea, that is not the case. The New Chilean System is very different from those alcohol tax systems successfully challenged in the past in that the New Chilean System does not distinguish by type, but rather applies identical objective criteria to all products. Chile argues that the European Communities is asking the Panel to expand the interpretation of Article III in ways that are unprecedented and unwarranted.

4.25 Chile also indicates that the major distilled spirits exporting companies and countries have enjoyed success in past cases in challenging tax laws where there was explicit discrimination based on national origin of the products or where, as in the case of the Japanese and Korean systems, the favored product was of a type that effectively could only be domestic. Now the European Communities asks this Panel to go further to ban tax distinctions based on the neutral criterion of alcohol content, at least if the distinction is not directly proportional to the difference in alcohol content. For the European Communities, it is apparently not sufficient that taxes not discriminate by national origin or by type, nor is it sufficient that the results of the application of the neutral criterion will favor some imports as well as domestic products and disfavor some domestic products as well as imports. Finally - and perhaps most significantly - the European Communities ignores the fact that the use of this objective criterion of alcohol content will enable foreign and domestic producers alike to adapt their products in a very simple process (dilution with water) if they wish to obtain the most favored tax treatment.

4.26 Further, Chile states that if the Panel accepts the EC reasoning, it would not be a far step from such an interpretation to strike down national standards that, though based on objective criteria and applied without regard to national origin, had the effect of being less convenient or more burdensome for many foreign producers than for many domestic producers.

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

B. "DIRECTLY COMPETITIVE OR SUBSTITUTABLE"

1. Overview

4.28 **The European Communities argues** that pisco and the other distilled spirits are "directly competitive or substitutable".

4.29 In response, **Chile argues** that the European Communities has not established that other distilled spirits are directly competitive or substitutable with pisco. Chile does not deny that there is **some** degree of substitutability among various distilled spirits, but Chile disagrees that this degree is large enough so as to fall within the **directly** competitive or substitutable products in the Chilean market, within the meaning of Article III:2 second sentence.

4.30 Chile goes on to claim that the EC arguments on this point are at least relevant (though unpersuasive) with regard to the Transitional System, which imposes different rates of taxation based on type of distilled spirit. However, the question of whether the different types of distilled spirits are directly competitive or substitutable does not arise in the New Chilean System. The liquor tax systems of Japan and Korea examined by WTO panels involved tax structures organized around product type. The New Chilean System is an entirely different system where differentiation in taxation is based on alcohol content, not type of distilled spirit.

2. General Consideration

4.31 **The European Communities begins with the argument** that the scope of "directly competitive or substitutable" products is broader than that of "like" products. Products which may be too different in terms of physical characteristics or end uses to qualify as "like" for the purposes of the first sentence of Article III:2 may still be found to be "competitive or substitutable" for purposes of its second sentence.⁴³

4.32 The European Communities points out that in *Japan - Taxes on Alcoholic Beverages II*, the Appellate Body ruled that the terms "like product" must be construed "narrowly" in the first sentence of Article III:2.⁴⁴ This interpretation was deemed necessary in view of the fact that, as put by one of the complainants in that dispute, Article III:2, first sentence, operates as "guillotine": once it has been established that two products are "like", any tax differential between them is deemed prohibited, without it being necessary to ascertain whether the tax differential is applied "so as to afford protection".

4.33 Further, the European Communities notes that the Appellate Body arrived at its conclusion that the term "like" should be construed "narrowly" as follows:

⁴³ Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II*, *supra.*, p. 25.

⁴⁴ *Ibid.*, pp. 19-20.

Because the second sentence of Article III:2 provides for a separate and distinctive consideration of the protective aspect of a measure in examining its application to a broader category of products that are not "like products" as contemplated by the first sentence, the European Communities agrees with the Panel that the first sentence of Article III:2 must be construed narrowly so as not to condemn measures that its strict terms were not meant to condemn. Consequently, the European Communities agrees with the Panel also that the definition of 'like products' in Article III:2, first sentence, should be construed narrowly.⁴⁵

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

4.35 According to the European Communities, the drafting history of the GATT 1947 also supports a broad interpretation of the scope of "directly competitive or substitutable" products. At the Geneva session of the Preparatory Committee, delegates cited several examples of products that could be considered sufficiently "competitive" to trigger the application of Article III:2, second sentence. These examples included quite broad categories of products, such as apples and oranges⁴⁶; linseed oil and tung oil⁴⁷; and synthetic rubber and natural rubber.⁴⁸ The record discloses that no disagreement was expressed by delegates with respect to the breadth of these examples. At the Havana Conference, some delegates mentioned even larger categories of products, such as tramways and busses or coal and fuel as examples of "directly competitive or substitutable" products.⁴⁹

4.36 The European Communities argues that past panels which have interpreted the notion of "directly competitive or substitutable products" have also taken a broad approach. The Panel Report on *Japan - Taxes on Alcoholic Beverages I*⁵⁰ found that shochu and all other distilled spirits were directly competitive and substitutable on the Japanese market. This finding was confirmed in *Japan - Taxes on Alcoholic Beverages II*.

4.37 Also, the European Communities points out that another example is provided by the Panel Report on *EEC - Measures on Animal Feed Proteins*, which concluded that vegetable proteins and

⁴⁵ Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II*, *supra.*, pp. 20-21. The European Communities points out that the Panel Report on *Japan - Taxes on Alcoholic Beverages*, (hereafter, "*Japan - Taxes on Alcoholic Beverages II*"), adopted on 1 November 1996, WT/DS8/R, WT/DS10/R, WT/DS11/R, para. 6.22 states: "Giving a narrow meaning to 'like products' is also justified by the inescapability of violation in case of taxation of foreign products in excess of [*sic*] domestic products".

⁴⁶ E/PC/T/A/PV/9, p. 7.

⁴⁷ E/CONF.2/C.3/SR.11, p.1 and Corr. 2.

⁴⁸ E/CONF.2/C.3/SR.11, p. 3.

⁴⁹ E/Conf.2/C.3/SR.40, p. 2. Nevertheless, the European Communities notes that unlike in the case of the examples mentioned at Geneva, there was some disagreement among delegates with respect to these examples.

⁵⁰ Panel Report on *Japan - Customs Duties, Taxes and Labelling Practices on Imported Wines and Alcoholic Beverages*, BISD 34S/83 (hereafter, "*Japan - Taxes on Alcoholic Beverages I*").

skimmed milk powder were "directly competitive or substitutable" products for the purposes of applying the second sentence of Article III:5.⁵¹

4.38 **Chile contends** that despite the slight and temporary practical effect of the issue whether pisco is directly competitive or substitutable with any other distilled spirits, at least as a matter of precedent, it is important to emphasize that the European Communities has failed to substantiate its claim that pisco is directly competitive or substitutable in the sense of Article III with European spirits.

4.39 Chile goes on to state that the European Communities has been careful to include many paragraphs and even some charts purporting to fulfill each of the elements necessary to demonstrate that other distilled spirits are directly competitive or substitutable with pisco in the Chilean market. The Panel should not simply accept the EC's contentions which, in the view of Chile, do not stand up to close scrutiny as proofs that the products are directly competitive or substitutable. Chile notes that the European Communities has provided what are undoubtedly thick studies and annexes, and the Transitional System has some superficial similarities to the Japanese and Korean cases. Chile urges the Panel to reject the EC's arguments. Accepting the EC's contentions regarding the Transitional System would set an adverse precedent that would constitute yet one further significant step toward requiring harmonization of taxation of increasingly disparate products - even as panels continue to claim that such is not their objective or intent.

4.40 Chile then states that the Panel should instead find that the European Communities has failed to meet its burden of demonstrating that pisco is directly competitive or substitutable with other distilled spirits in the Chilean market.

3. Potential Competition

4.41 **The European Communities stresses** that Article III:2, second sentence, is concerned not only with tax differentials between products that are already *actually* competitive or substitutable on a given market, but also with tax differentials between products that are *potentially* competitive or substitutable. Furthermore, the notion of potential competition must be deemed to include not only competition that would exist "but for" the tax measures at issue, but also competition that could be reasonably expected to develop in the future having regard, for example, to existing trends in the market concerned or to the situation prevailing in other markets.

4.42 The European Communities explains that the relevance of potential competition, as defined above, flows from the well-established principle that GATT Article III does not protect export volumes but competitive opportunities. As stated by the Appellate Body in *Japan – Taxes on Alcoholic Beverages II*:

[I]t 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.⁵²

⁵¹ Panel Report on *EEC – Measures on Animal Feed Proteins*, BISD 25S/49, para. 4.3.

⁵² Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II*, *supra.*, p. 16. See also Working Party on *Brazilian Internal Taxes*, adopted 30 June 1949, II/181, 185, para. 16; Panel Report on *United States - Taxes on Petroleum and Certain Imported Substances*, *supra.*, para. 5.1.9; Panel Report on *United States - Measures affecting Alcoholic and Malt Beverages* (hereafter, "*United States – Malt Beverages*"), BISD 39S/206, para. 5.6; and Panel Report on *United States - Measures Affecting the Importation, Sale and Use of Tobacco*, BISD 41S/131, paras. 99-100.

4.43 The European Communities states that the recognition of the relevance of potential competition for the purposes of Article III:2, second sentence, is of particular importance in the present dispute. In the first place, pisco has benefited from protective taxation for a long time. As a result, the current level of actual competition between pisco and other spirits is necessarily less than the level that could have developed under equal tax conditions. Secondly, distilled spirits, like many foods and beverages, are so-called "experience goods", i.e., goods which must be purchased and consumed in order to appreciate their aptitude to satisfy the consumers' needs. Furthermore, consumption of spirits is largely based on habits, which only change gradually. For those reasons, market penetration is generally slow and short-term reactions to price changes tend to be relatively low.

4.44 **Chile replies** that the European Communities offers as an excuse that cross-elasticities are often low for products that are new to the market. Such a comment hardly seems appropriate to the case of whisky, which has a very long history in the Chilean market.

4. Relevant Factors and Their Evidentiary Weight

(a) Relevant Factors

4.45 **The European Communities points out** that in *Japan – Taxes on Alcoholic Beverages II*, the Appellate Body noted that "how much broader [the] category of 'directly competitive or substitutable products may be in a given case' is a matter for the panel to determine based on all relevant facts in that case".⁵³

4.46 Also, according to the European Communities, in the same report, the Appellate Body referred specifically to the following factors as being relevant for assessing whether two products are "directly competitive or substitutable"⁵⁴:

- (i) the physical characteristics of the products;
- (ii) their end-uses;
- (iii) their tariff classification; and
- (iv) the "market place", and in particular the degree of elasticity of substitution between the products concerned.

4.47 **In response, Chile states** that the question whether products are like, directly competitive or substitutable under various GATT rules has provoked many disputes over the years, but has not led to the development of any particularly clear or objective standards to guide WTO member governments or their legislatures. The case by case approach of the panels to date may be thought desirable, insofar as it leaves panels considerable discretion for judgement as to what are permissible and impermissible distinctions, but the cost of that discretion is a loss in predictability and certainty for national governments and legislatures.

4.48 Thus, Chile argues that panels have taken the approach of considering a variety of factors (none of which are considered individually dispositive) rather than applying any readily apparent formula. In reading the various decisions, it is impossible to avoid the sense that there is as much intuition as science lying behind past GATT and WTO decisions. Under such a standard, Chile

⁵³ Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II*, *supra.*, p. 25.

⁵⁴ *Ibid.*

disagrees with the EC claim that its finest single malt whiskeys and its rarest cognacs must be viewed as directly competitive or substitutable with *Pisco corriente*.

4.49 Chile states that the EC argument in this case nominally tracks the factors that the Appellate Body endorsed in the *Japan - Taxes on Alcoholic Beverages II* case. Those factors include such matters as physical characteristics, common end-uses, and tariff classifications, but also the "market place".

4.50 Chile argues that in sum, each supposed element of the EC case appears ill-founded. While perhaps every factor need not be present with equal force to find two products to be directly competitive or substitutable, every element should not be so weak as the evidence presented by the European Communities. Accordingly, the Panel should find that the European Communities has not shown that pisco and other distilled spirits are directly competitive or substitutable, and that the Transitional System is consistent with Article III:2, even for the brief period it remains in force.

(b) Evidentiary Weight

(i) *Physical Characteristics*

4.51 **The European Communities points out** that as illustrated by the drafting history of Article III:2 and past panel reports, two products need not have the same physical characteristics in order to be "directly substitutable and competitive". As noted by the Panel Report on *Japan - Taxes on Alcoholic Beverages II* :

[C]ompetition can and does exist among products that do not necessarily share the same physical characteristics. In the Panel's view, the decisive criterion is whether they have common end uses ...⁵⁵

4.52 According to the European Communities, at the same time, however, it is obvious that if two products have sufficiently similar physical characteristics, such similarity may in and of itself be sufficient to conclude that the products in question are apt to serve for the same end-uses and, therefore, that they are "directly competitive or substitutable".

4.53 The European Communities argues that in order to be "directly substitutable and competitive" two products need not have the same physical characteristics. In fact, if there were no differences in physical characteristics between two products, they would be "like" instead of "directly competitive or substitutable". The decisive criterion for determining whether two products are "directly competitive or substitutable" is whether they have common end-uses. At the same time, it seems obvious that if two products have sufficiently similar physical characteristics, such similarity may in and of itself be sufficient evidence to conclude that the products in question are apt for the same end-uses and, therefore, that they are "directly competitive or substitutable".

4.54 According to the European Communities, the existence of differences in physical characteristics between Japanese shochu and the other distilled spirits did not prevent the two panels on *Japan - Taxes on Alcoholic Beverages I* and *II* from concluding that they were directly "competitive and substitutable" in the Japanese market. Likewise, in *Korea - Taxes on Alcoholic Beverages*, the panel concluded that soju was "directly competitive or substitutable" with a number of other distilled spirits, despite the existence of differences with respect to factors such as alcohol content, ageing, colour or flavouring.⁵⁶ The differences between pisco and other distilled spirits are

⁵⁵ Panel Report on *Japan - Taxes on Alcoholic Beverages II*, *supra.*, para. 6.22.

⁵⁶ Panel Report on *Korea - Taxes on Alcoholic Beverages*, 17 September 1998, WT/DS75/R and WT/DS84/R, para. 10.67.

similar to those existing between shochu or soju and other distilled spirits. Therefore, those differences cannot exclude of themselves a finding that pisco is "directly competitive or substitutable" with other distilled spirits.

4.55 **In rebuttal, Chile states** that not all physical characteristics of the products involved need to overlap for the products in question to be considered "directly competitive or substitutable". However, Chile does consider that the European Communities needs to demonstrate more than a coincidence of one physical characteristic, in this case the alcohol content of the beverage, before claiming that products are *directly* competitive or substitutable in the sense required by Article III.

(ii) *End-uses*

4.56 **The European Communities states** that as observed by the panel on *Japan – Taxes on Alcoholic Beverages II* in the above quoted passage, commonality of end-uses is the "decisive criterion" for establishing whether two products are "directly competitive or substitutable". In fact, the other criteria are relevant only to the extent that they can provide an indication as to the existence of such commonality of end-uses.

4.57 According to the European Communities, in order to be "directly competitive or substitutable" for the purposes of Article III:2, second sentence, two products need not be competitive or substitutable with respect to all their possible end-uses. This was made clear by the Appellate Body in *Canada – Periodicals*.⁵⁷ In that case, Canada argued that US magazines were not "directly competitive or substitutable" with Canadian magazines because, while they provided a reasonable substitute as an advertising medium, they were poor substitutes as an entertainment and communication medium. Thus, according to Canada, US and Canadian magazines were only "imperfect substitutes". The Appellate Body dismissed this argument by pointing that a case of "perfect substitutability" would fall within Article III:2, first sentence.

4.58 The European Communities goes on to state that similarly, in *Japan - Taxes on Alcoholic Beverages I*, the panel based its conclusion that Japan's Liquor Tax Law violated Article III:2, second sentence, on the finding that there existed direct competition or substitutability among the liquors concerned, "even if not necessarily in respect of all the economic uses to which the products may be put".⁵⁸

4.59 Further, the European Communities contends that from the principle that Article III is concerned with the protection of competitive opportunities, it follows that the end-uses to be taken into account include all the objective (or functional) end-uses to which the products may be put, irrespective of whether the products are currently being employed for those end-uses in the market concerned. Similarity of actual end-uses may, of course, provide further evidence of substitutability, but is not required for a finding that products are "directly competitive or substitutable".

(iii) *Tariff Classification*

4.60 **In the view of the European Communities,** tariff nomenclatures classify products in accordance with their physical characteristics and end-uses. For that reason, as noted by the Appellate Body in *Japan – Taxes on Alcoholic Beverages II*, "if sufficiently detailed, tariff classification can be a helpful sign of product similarity".⁵⁹

⁵⁷ Appellate Body Report on *Canada - Periodicals*, *supra.*, p. 28.

⁵⁸ Panel Report on *Japan - Taxes on Alcoholic Beverages I*, *supra.*, para. 5.7.

⁵⁹ Appellate Body Report on *Japan – Taxes on Alcoholic Beverages II*, *supra.*, p. 21.

4.61 The European Communities points out that tariff classification has already been relied upon by several previous panel reports in order to make a "like" product determination.⁶⁰ *A fortiori*, tariff classification may also be relevant for the purposes of determining whether two products fall within the broader category of "directly competitive or substitutable" products.

4.62 According to the European Communities, two products falling within the same tariff position may be covered by different bindings and vice-versa. Tariff nomenclatures such as the Harmonized System classify products according to their objective characteristics. For that reason, they may provide useful guidance in order to determine whether products are "like" or "directly competitive or substitutable".

4.63 **Chile concedes** the obvious point that all distilled spirits share a common tariff category; however, according to Chile, the point is of virtually no legal significance, because there are 4-digit HS categories which include products which are obviously not "directly competitive or substitutable"; for example, aviation gas and vaseline white oil (HS 2710), mackerel and caviar (HS 1604), lobster and crabmeat meal (HS 0306), and ivory and nails (HS 0507).

(iv) *Market Place*

4.64 **The European Communities notes** that in *Japan – Taxes on Alcoholic Beverages II*⁶¹, the Appellate Body approved the Panel's decision to look at the "market place" and in particular to the cross-price elasticity between the products concerned. At the same time, however, the Appellate Body emphasised that cross-price elasticity is "not *the* decisive criterion". According to the Appellate Body, cross-price elasticity is but one of the means of examining the relevant market. In turn, looking at the relevant market is but "one among a number of means" of identifying the products that are directly competitive or substitutable in a particular case.

4.65 According to the European Communities, a high rate of cross-price elasticity may be sufficient to establish that two products are directly competitive or substitutable for the purposes of the second sentence of Article III:2. The opposite, however, is not necessarily true. A relatively low rate of cross-price elasticity does not of itself exclude the possibility that two products may be "directly competitive or substitutable". Such a low rate may simply be the result of the tax measures at issue. Or it may reflect the fact that imports are new entrants in the market concerned, a hypothesis that may be of particular significance in the case of experience goods such as those at issue in this dispute.

4.66 The European Communities further points out that as noted by the Panel Report on *Japan – Taxes on Alcoholic Beverages II*:

... a tax system that discriminates against imports has the consequence of creating and even freezing preferences for domestic goods. In the Panel's view, this meant that consumer surveys in a country with such a tax system would likely understate the degree of potential competitiveness between substitutable products.⁶²

4.67 According to the European Communities, when "looking at the market-place," it may also be relevant to consider, in addition to cross-price elasticity, other factors such as the actual end-uses of the products (as opposed to their objective end uses), their availability in different sales channels or

⁶⁰ Panel Report on *Japan - Taxes on Alcoholic Beverages I*, *supra.*, para. 5.6. See also the Panel Report on *EEC – Measures on Animal Feed Proteins*, *supra.*; and Panel Report on *United States – Standards for Reformulated and Conventional Gasoline*, WT/DS2/R, adopted on 20 May 1996.

⁶¹ Appellate Body Report on *Japan – Taxes on Alcoholic Beverages II*, *supra.*, p. 25.

⁶² Panel Report on *Japan - Taxes on Alcoholic Beverages II*, *supra.*, para. 6.28, citing the Panel Report on *Japan - Taxes on Alcoholic Beverages I*, *supra.*, para. 5.7.

the way in which they are advertised. Nevertheless, when assessing the evidence related to these factors, it must always be borne in mind that Article III:2 is concerned with the protection of competitive opportunities and not of actual competition. Evidence that two products are sold in the same channels and used for the same purposes can be taken as evidence that they are "directly competitive or substitutable". The absence of such evidence, however, does not, in and of itself, lead to draw the opposite conclusion.

4.68 **Chile replies** that the European Communities offers as an excuse that cross-price elasticities are often low for products that are new to the market. Such a comment hardly seems appropriate to the case of whisky, which has a very long history in the Chilean market. Further, Chile argues that the regression analysis submitted by the European Communities has serious methodological flaws. Chile further states that the Search Marketing surveys submitted by the European Communities have inconsistent results.

4.69 Chile further argues that common distribution channels are not strong evidence, and multi-purpose channels are weaker still than dedicated channels.

4.70 **The European Communities responds** that the regression analysis it has submitted to the Panel was conducted by a consultation firm at the request of the Chilean pisco industry. Further, it claims that the regression analysis Chile submitted to the Panel has a more serious flaw of multicollinearity.

5. Product Categories

4.71 **The European Communities argues** that all pisco must be considered as a single product for the purposes of Article III:2. Accordingly, the existence of direct competition or substitutability must be assessed with respect to the category of pisco as a whole and not with respect to each of the four types of pisco.

4.72 The European Communities claims that, according to the regulations in force, the four different varieties of pisco are distinguished solely in terms of their alcohol strength.⁶³ This means that, for example, any pisco with 43° or more is entitled to use the designation *gran pisco*, irrespective of the varieties of muscat grape from which it is made, the length of its ageing period or the type of container in which it has been matured. As acknowledged by Chile during the consultations⁶⁴, all that is required in order to produce *pisco especial* or *pisco corriente* instead of *gran pisco* or *pisco reservado* is adding some more water before bottling the product.

4.73 The European Communities then argues that this difference does not warrant treating each of them as a distinct product for the purposes of Article III:2, second sentence, especially since, as will be shown below, most pisco is consumed mixed with other non-alcoholic beverages or "on the rocks". In *Japan – Taxes on Alcoholic Beverages II*, the panel noted that "a difference in the alcoholic strength of two products does not preclude a finding of likeness, especially since alcoholic beverages are often drunk in diluted form".⁶⁵

4.74 Further, the European Communities points out that as shown in Tables 7 and 8 below, most other distilled spirits are also bottled at different alcohol strengths. Japanese shochu, for instance, is

⁶³ Article 13 of Decree 78/1986 (EC Exhibit 13). In this connection, the European Communities notes that Chile claimed in Chile's answers to questions from the EC, dated 24 February 1998 (EC Exhibit 2) that each of the four types of pisco is made from different varieties of grapes and according to a different manufacturing process, in particular as regards the maturation phase.

⁶⁴ Chile's answers to questions from the EC, dated 24 February 1998 (EC Exhibit 2).

⁶⁵ *Japan - Taxes on Alcoholic Beverages II, supra.*, para. 6.23.

bottled in a range from 20° to 45°. Yet, the two panels on *Japan – Taxes on Alcoholic Beverages I and II* have treated all shochu as a single product, irrespective of its alcohol content.

4.75 The European Communities disagrees with Chile's claim that *gran pisco* and *pisco reservado* are products of higher quality and, for that reason, are sold at higher prices than the other types of pisco.⁶⁶ There is no clear correlation between quality/prices and alcohol strength. The European Communities submitted a survey of retail prices conducted in May 1998 by Search Marketing S.A. at five big super-markets of Santiago (hereafter, "the 1998 SM price survey").⁶⁷ This survey shows that price differentials among brands of the same alcohol strength are often larger than price differentials among strength categories within the same brand. Thus, for example, *pisco especial* of high quality brands such as "Alto del Carmen", "Control de Guarda" or "Mistral" is more expensive than *pisco reservado* or even *gran pisco* of average quality such as the basic "Capel" and "Control" brands.

4.76 The European Communities further argues that, with respect to the samples of pisco provided to the Panel⁶⁸, the bottles and labels of all piscos of the same brand tend to be identical, except for the mandatory indication of their respective alcohol strength and denomination. Promotional claims are generally made with respect to all products of the same brand, rather than with respect to specific alcohol strengths.

4.77 Further, according to the European Communities, the pisco industry has pursued a marketing strategy apparently aimed at segmenting the pisco market in order to expand its consumer base and raise unit profitability. This policy has taken two different courses. The first of them was to develop product categories based on alcohol strength, a strategy that was officially sanctioned by Decree-Law 78/1986. The second and more recent trend is to extend the line of brands of each producer. Thus, in addition to its basic brand "Capel", Capel is now selling the "prestige" brands "Artesanos de Cochiguaz" and "Alto del Carmen", as well as less expensive brands such as "Limari" and "Límite". In turn, Control's brand portfolio includes, besides the brand "Control", the brands "Control de Guarda", "La Serena", "Mistral", "Tres Erres" and "Sotaqui". The identity of these new brands has been built upon motives such as the place of origin of the grapes, traditional manufacturing methods, product age claims, fancy packaging and differentiated advertising.⁶⁹

4.78 The European Communities further argues that most brands are sold in a wide range of strengths, with the consequence that the number of brands/strengths now available in the market may be close to 100, despite the fact that the two main producers account for more than 90 % of the sales. The proliferation of new brands, each with a different identity, has blurred the segmentation based on alcohol content which the industry had attempted to build on the basis of the legal categorisation established in Decree 78/1986. As already mentioned above, inter-brand differences in quality and price may now be greater than intra-brand differences between strength categories.

4.79 The European Communities then concludes that in any event, pisco is by no means unique in being sold in different types/qualities. If anything, pisco is a much more homogeneous product than other spirits. For instance, to mention but the best known types of whisky, one may distinguish between malt Scotch, grain Scotch, blended Scotch, Canadian, Irish, Bourbon and Rye, each with its own specific characteristics. Moreover, within each of those types of whisky, it is still possible to

⁶⁶ Chile's answers to questions from the European Communities, dated 24 February 1998 (EC Exhibit 2).

⁶⁷ A copy is attached as EC Exhibit 23. The European Communities notes that additional confirmation is provided by the price data shown in the 1997 report of The International Wine & Spirits Record (hereafter the "IWSR Report"), pp. 80-81, Table G (EC Exhibit 19).

⁶⁸ EC Exhibits 62-71.

⁶⁹ See e.g. the description of Control's different brands contained in Control's Internet home page (EC Exhibit 51).

draw further distinctions. Thus, in the case of blended Scotch, the trade makes a distinction between "premium" blended Scotch (12 or more years old) and "standard" blended Scotch (less than 12 years old). The differences in terms of quality and price between the four varieties of pisco alleged by Chile are not greater than those that exist between different types/qualities of whisky.

4.80 In response to a question posed by the Panel about product categories and comparisons, **Chile contends** that there are both similarities and differences between, on the one hand, the cases of Boss Suits/Discount Store Suits, Mont Blanc Pens/Bic Pens and, on the other hand, pisco and whisky or other distilled spirits. In the cases of the suits and the pens, one product is essentially a luxury version of the other, with corresponding differences in price and presumably quality. As a result, in most markets there is probably little substitutability between the products, as poor consumers cannot afford Boss suits or Mont Blanc pens, while rich ones will not buy discount suits or pens where a choice is available (although Chile thinks that even rich consumers may be more likely to use Bic Pens for some purposes than to buy cheap suits). A hypothetical "average" consumer of suits might see some substitutability, but more likely would find neither a satisfactory alternative. Chile believes that the differences in market segment and price are such that a higher tax on the luxury product would not infringe Article III:2, even if all Boss suits were imported and all discount suits were domestically made.

4.81 Chile goes on to argue that the case of pisco and other distilled spirits has some similarities, but also some important differences. The analogy to the pens and suits cases would be more precise if one compared a cheap, 30° *pisco corriente* to a high quality *gran pisco*, since one is a luxury version of the other.

4.82 In Chile's view, the more appropriate analogies when comparing *pisco corriente* and, for example, a good Scotch whisky or French cognac would be the difference between a cheap apple and a top quality orange; Belgian endives and cabbage, or a cheap soybean oil and a high quality extra virgin olive oil from Umbria. In each of these examples, the two different products are capable of being used for the same purposes and, at some level of price and consumer desperation, might be used interchangeably. However, their markets are in practice very different and they would not be considered directly competitive or substitutable by consumers in most markets. Indeed, except when pursuing the lowest possible taxes for its products, the Scotch Whisky Association itself would doubtless wholeheartedly reject the idea that its products were directly competitive or substitutable with *pisco corriente*.

4.83 **The European Communities notes** that Chile's changes of analogies from vehicles to vegetables does not help its case. *Pisco corriente* and "a good Scotch whisky" are compared by Chile, respectively, to a "cheap apple" and a "top quality orange". However, apples and oranges were precisely one of the examples of "directly competitive and substitutable products" cited by the drafters of GATT. The qualification that the apple must be a "cheap" one and the orange "top quality" is inappropriate. The present case is not just about expensive "good" Scotch and cheap *pisco corriente*. It is about all kinds of whisky and of pisco. The European Communities has shown that the prices of pisco and of other spirits already overlap, despite differences in taxation.

4.84 According to the European Communities, the example of "cheap soybean oil" and "high quality extra virgin olive oil from Umbria" is flawed for similar reasons. The relevant comparison would be with olive oil and soybean oil, without any further qualifications.

4.85 Also, the European Communities states that endives are not a "luxurious" product in Belgium. Over time, they could become less expensive also in Washington DC, provided that they are not subject to a "luxury" tax. In Europe, avocados or kiwis could have been considered as a "luxury" item product 20 years ago. They would have remained so, had they been subjected to protective taxation.

6. Arguments on Each Factor

(a) Physical Characteristics

4.86 **The European Communities argues** that pisco and the other distilled spirits share the same basic physical characteristics. All of them have the essential feature of being beverages containing alcohol obtained from naturally fermented ingredients by using similar distillation processes. The choice of raw materials from which the alcohol is distilled and/or the use of post-distillation processes such as ageing, colouring or flavouring confer to each type of distilled spirits its own distinctive identity. The resulting differences, however, are not so important as to render the various types of distilled spirits non-substitutable with each other.

4.87 In Tables 7 and 8 below, the European Communities compares the physical properties and manufacturing processes of pisco and the main types of imported distilled spirits. The essential differences between them may be summarised as follows:

- (i) Raw materials: like most types of brandy (*e.g.*, cognac, armagnac, sherry brandy⁷⁰), pisco is distilled from grape wine. Other spirits are made from grains (whisky, korn, gin, vodka, aquavit, soju, shochu), potatoes (vodka, soju, shochu), sugar cane or molasses (rum, ouzo), fruits (fruit brandies) or neutral spirits (gin, vodka, aquavit, soju, shochu).
- (ii) Colour: the colour of pisco may go from "clear" or "white" to "light amber". Whisky and the majority of other brandy types are "amber".⁷¹ Rum, aquavit and fruit brandies may be both "white" and "amber". Gin, vodka, ouzo and korn are generally "clear" or "white".
- (iii) Ageing: like whisky and brandy, pisco is matured in wooden casks. This differentiates pisco from spirits such as vodka, aquavit, korn or ouzo, which are not aged. Rum and certain types of fruit brandy may also be aged in wooden casks.
- (iv) Flavouring: some spirits have specific flavourings added during or after distillation. For instance, gin has the distinctive feature of being flavoured with juniper berries
- (v) Alcohol content: pisco is bottled at 30° to 50°. Whisky, gin, rum, vodka, ouzo, korn and aquavit, are bottled at 37/37.5° to 50°. Brandy is bottled at 36 ° to 50 °.

⁷⁰ The European Communities notes that brandy can also be made from grape marc (*e.g.* grappa)

⁷¹ The European Communities notes that grappa is generally "white".

Table 7⁷²

Physical characteristics of distilled spirits

	<u>Alcohol</u> (% vol.)	<u>Strength</u>	<u>Colour</u>	<u>Added flavourings</u>	<u>Body/flavour</u> (sensory attributes)
Whisky	37-50		Amber	Yes	Medium to high
Brandy	36-50		Amber/Clear*	Yes	Medium
Gin	37-50		Clear	Yes	Light to medium
Rum	37-50		Clear/Amber	Yes	Light to medium
Vodka	37-50		Clear	Yes	Light
Pisco	30-50		Clear/light amber	Yes	Light to medium
Soju	25-45		Clear/light amber	Yes	Light to medium
Shochu	20-45		Clear/ light amber	Yes	Light to medium
Ouzo	37.5-50		Clear	Yes	Medium to high
Korn	32-45		Clear	No	Light to medium
Aquavit	37.5-50		Clear/light amber	Yes	Light to medium
Fruit brandy	37.5-45		Clear***	Yes**	Light to medium

* Grappa is an example of clear brandy

** Certain countries (*e.g.*, EC) do not permit flavourings in whisky, rum and fruit brandies

*** Except plum brandy (light amber/amber)

⁷² EC First Submission, Table 10.

Table 8⁷³

Manufacturing processes of distilled spirits

	<u>Raw material*</u>	<u>Distillation strength (% vol.)</u>	<u>Method of distillation</u>	<u>Maturation in wooden casks</u>	<u>Reduction with water to bottling strength</u>	<u>Bottling strength (% vol.)</u>
Whisky	Grain	Less than 95	Continuous or pot still	Yes	Yes	37-50**
Brandy	Grapes	Less than 95	Continuous or pot still	Yes	Yes	36-50
Gin	Grain Neutral spirits	At or above 95	Continuous	No	Yes	37-50
Rum	Sugar cane / Juices Molasses	Less than 96	Continuous	Varies	Yes	37-55
Vodka	Grain Potatoes Neutral spirit	At or above 95	Continuous	No	Yes	37-50
Pisco	Grapes	Less than 95	Pot still	Yes	Yes	30-50
Soju	Grain Potatoes Neutral spirits	At or above 85	Continuous or pot still	Varies	Yes	25-45
Shochu	Grain potatoes Neutral spirits	At or above 85	Continuous or pot still	Varies	Yes	20-45
Ouzo	Molasses	55-80	Pot still	No	Yes	37.5-50
Korn	Whole grain	At or above 95	Continuous	No	Yes	37.5-50
Aquavit	Grain molasses Neutral spirits	At or above 95	Continuous	No	Yes	37.5-50
Fruit brandy	Fruits Neutral spirits	Less than 86	Continuous or pot still	No***	Yes	37.5-50

* Neutral spirit is an alcohol spirit distilled at no less than 95 % vol. from any material of agricultural origin.

** Many countries set a minimum alcohol strength of 40 % vol. for whisky, *e.g.*, the EC, the USA and Chile. In some countries, higher or lower minimum strength requirements apply, *e.g.*, Australia (37 %), Brazil (38 degrees Gay Lussac) and South Africa (43 %). Canada sets no minimum strength for whisky.

*** Except plum brandy.

⁷³ EC First Submission, Table 11.

4.88 According to the European Communities, the above differences are relatively minor and do not prevent pisco and the other distilled spirits from being "directly competitive or substitutable" within the meaning of Article III:2, second sentence. To the contrary, the degree of similarity between pisco and other spirits is such that, even in the absence of any other evidence, it could be sufficient for this Panel to conclude that they are "directly competitive or substitutable" products.

4.89 The European Communities considers that, indeed, some of the differences between pisco and the other distilled spirits would not even be sufficient to exclude a finding of "likeness". In accordance with well-established case law, "minor differences in taste, colour and other properties (including different alcohol contents) do not prevent products from qualifying as like products".⁷⁴ In particular, previous panels have determined that differences in alcohol content do not, of themselves, make two liquors "unlike". Thus, the two panels on *Japan – Taxes on Alcoholic Beverages I* and *II* concluded that shochu was "like" vodka, even though shochu has generally a lower alcohol content. *A fortiori*, differences in alcohol content cannot prevent two products from falling within the broader category of "directly competitive or substitutable" products.

4.90 The European Communities points out that Panel Report on *Japan – Taxes on Alcoholic Beverages II* noted in this regard that:

... a difference in the physical characteristics of alcohol strength of two products did not preclude a finding of likeness, especially since alcoholic beverages are often drunk in diluted form ...⁷⁵

4.91 In the view of the European Communities, as evidenced by Tables 7 and 8, the differences between pisco and other distilled spirits are similar to the differences between Japanese shochu and other distilled spirits. For example, shochu is generally made from unmalted cereals, potatoes or neutral spirits, unlike brandy, rum, whisky or fruit brandies; is not usually aged or coloured, unlike brandy, whisky or rum; and has an alcohol content of 25° to 30°, unlike the main types of western spirits, which have a strength of 37/37.5° to 50°. Yet, despite those differences, shochu was found to be directly competitive and substitutable with the other distilled spirits falling within HS 22.08 by the two successive panels on *Japan – Taxes on Alcoholic Beverages I* and *II*.

4.92 According to the European Communities, the characteristic of being a "distilled alcoholic beverage" is the essential feature of all the products in dispute. Even if there was no other evidence in the record establishing the existence of actual competition on the Chilean market between pisco and other spirits, the fact that all of them share that essential characteristic could, in and of itself, be sufficient to conclude that they are objectively apt to serve the same end-uses and are therefore "directly competitive or substitutable" within the meaning of the second sentence of Article III:2.

4.93 **Chile responds** that as to the much more objective question of common ingredients and physical characteristics, it is apparent that the products share virtually no ingredients or characteristics, other than containing alcohol. One might as readily find trucks and bicycles to be substitutable because both contain wheels.

4.94 Chile considers that it is not irrelevant that all the products in question are distilled alcoholic beverages. However, in the evaluation whether the products are directly competitive or substitutable, this single common characteristic is not in itself sufficient.

4.95 In Chile's view, previous panels considered that to evaluate products as being directly competitive and substitutable, the complaining parties need to show evidence that the products in

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

⁷⁵ Panel Report on *Japan - Taxes on Alcoholic Beverages II*, *supra.*, para. 6.23.

question share not only physical characteristics (such as nature and quality), but also similar end-uses, channels of distribution and points of sale, marketing strategies, elasticity of substitution, and price.⁷⁶ The European Communities failed to submit to the Panel evidence that is conclusive or reliable. (Chile notes, for example, that in its evaluation the European Communities does not seem to take into account that pisco is based on perishable grapes produced domestically, whereas whisky and other distilled beverages are produced on the basis of grain, which can be produced, shipped and stored anywhere.)

4.96 Chile does not consider that all physical characteristics of the products involved need to overlap for the products in question to be considered "directly competitive or substitutable". However, Chile does consider that the European Communities needs to demonstrate more than a coincidence of one physical characteristic, in this case the alcohol content of the beverage, before claiming that products are *directly* competitive or substitutable in the sense required by Article III.

4.97 **The European Communities responds** that together, ethyl alcohol and water account for more than 99 % of the volume of all distilled spirits. Thus, even if Chile's assertion that pisco and other spirits share "virtually no ingredients or characteristics, other than containing alcohol", was true in all cases (*quod non*), it would hardly be condemning. According to the European Communities, the analogy drawn by Chile between ethyl alcohol and the wheels contained in bicycles and trucks is manifestly inept. Wheels do not account for 99 % of the components of either bicycles or trucks. Furthermore, the wheels of a truck are different from the wheels of a bicycle, whereas ethyl alcohol is always the same product, irrespective of the spirit in which it is contained. Finally, unlike pisco and the other distilled spirits, bicycles and trucks do not have similar end-uses. Someone invited to a cocktail party in Santiago is likely to be offered the choice between a pisco drink and a whisky drink. If Capel or Control want to ship some pisco from La Serena to Santiago, they are unlikely to do so by bicycle.

4.98 **Chile further states** that it does not deny that all spirits contain alcohol, nor that alcohol and water account for over 99% of volume. However, it cannot be concluded from here that all such spirits are directly competitive without much more proof.

4.99 Chile indicates that to accept that all spirits have the same end uses, because their basic constitution is water and alcohol, is to say that the only consideration for the consumer is the alcohol, no matter in which beverage it is contained. That is equivalent to say that pasta competes with bread, because both of them are basically wheat flour and water.

4.100 Chile notes that distilled spirits are by no means the only products that share that same characteristic. Wine and beer also contain approximately 99% of water and ethyl alcohol, but, according to the European Communities, they are not directly competitive and substitutable. Chile says that according to the European Communities, only some products that have the same intrinsic characteristics are competitors. That is highly questionable reasoning.

4.101 Chile further states that the European Communities having insisted, albeit unpersuasively, that distilled spirits should all be viewed as directly competitive or substitutable, it is impossible to sympathise with claims that each producer must have a right to market its product based on its alleged unique characteristics. The large exporters of distilled spirits cannot condemn systems for making tax distinctions based on arbitrary type distinctions and then turn around and insist that Article III not only tolerate but actively enforce those type distinctions when that suits the interest of the exporters. The creative effort to take the Panel through such mental gymnastics may warrant admiration on one level, but does not warrant support as a matter of interpretation of Article III:2.

⁷⁶ Report of the working party on *Border Tax Adjustments*, BISD 18S/97, para. 18; Panel Report on *Japan - Taxes on Alcoholic Beverages II*, *supra.*, paras. 6.22 and 6.28.

(b) End-uses

4.102 **The European Communities argues** that having the same basic physical characteristics, pisco and the other distilled spirits are intrinsically suitable for the same end-uses. Furthermore, there is evidence that, despite the competitive distortions caused by the current taxation conditions, pisco and the other distilled spirits are already being employed by the Chilean consumers for similar end-uses.

4.103 According to the European Communities, at the request of the EC spirits industry, Search Marketing S.A., a market research consultant based in Santiago, conducted in December 1997 a comprehensive survey of the drinking habits of a representative sample of spirits consumers (hereafter, the "1997 SM survey").⁷⁷ The findings of this study show that pisco and the other distilled spirits are drunk in similar styles, in the same occasions and places and by essentially the same categories of consumers.

4.104 **Chile argues** that to accept that all spirits have the same end-uses, because their basic constitution is water and alcohol, is to say that the only consideration for the consumer is the alcohol, no matter in which beverage it is contained.

(i) *Drinking styles*

4.105 **The European Communities presents** Table 9 which summarises the findings of the 1997 SM survey with respect to drinking styles.⁷⁸ According to the European Communities, it shows that pisco and the other distilled spirits are consumed in the same styles (straight, diluted with water, ice, soft drinks or fruit juice and in cocktails), even if the order of preferences may vary.

4.106 The European Communities explains that "mixed with a soft drink" is the most usual style for drinking pisco and all the other spirits, with the only exception of whisky. Nevertheless, the survey shows that there is also substantial overlapping of end-uses between whisky and pisco: the leading usage of whisky ("with ice") is also the third preference for pisco, whereas the leading usage of pisco ("mixed with soft drinks") is the third preferred style for drinking whisky. Moreover, both whisky and pisco are drunk "straight" and in "cocktail" by a significant percentage of respondents.

⁷⁷ EC Exhibit 21.

⁷⁸ 1997 SM survey, at p. i and Section 4.3 (EC Exhibit 21).

Table 9⁷⁹

Drinking styles

	Pisco	Whisky	Gin	Vodka	Tequila	Rum	Brandy
<u>With soft drink</u>	83	21	65	51	41	68	64
<u>Lemon ("sour")</u>	31	-	-	3	11	2	2
<u>Water</u>	-	1	8	2	5	3	-
<u>"On the rocks"</u>	22	75	31	36	16	30	28
<u>Cocktail</u>	9	5	12	29	33	7	4
<u>Straight</u>	9	24	16	18	31	15	36
<u>Other</u>	3	1	-	-	-	-	-
<u>Not Applicable /No response</u>	-	1	-	-	-	-	-

Basis: % of consumers of each type of spirit

(ii) *Drinking occasion*

4.107 According to the European Communities, Table 10 sets out the findings of the 1997 SM survey with respect to drinking occasions.⁸⁰ It shows a marked convergence across all spirits types. Not only are all spirits consumed in the same types of occasions, but the order of preference also tends to be the same. Thus, at "parties" and "with friends" are mentioned as the two top preferences in connection with pisco and all the other types of spirits, with only the exception of liqueurs.

⁷⁹ EC First Submission, Table 12.

⁸⁰ 1997 SM survey, p. ii and Section 4.3 (EC Exhibit 21).

Table 10⁸¹

Drinking occasions

	Pisco	Whisky	Gin	Vodka	Tequila	Rum	Brandy	Liqueur
<u>Parties</u>	61	55	54	59	62	54	57	20
<u>With friends</u>	59	64	77	65	72	72	65	42
<u>Family meetings</u>	46	43	23	29	22	33	35	27
<u>Week-ends</u>	34	24	23	35	24	18	27	6
<u>Aperitif</u>	15	14	8	15	8	9	9	8
<u>After work</u>	10	6	8	11	4	3	6	-
<u>During week</u>	8	6	8	7	4	3	6	-
<u>Digestive</u>	7	12	6	9	6	11	9	42

Basis: % of consumers of each spirit

(iii) *Drinking place*

4.108 According to the European Communities, Table 11 summarises the results of the 1997 SM survey with respect to the place of consumption.⁸² Again, it shows a remarkable convergence across all spirits types. Off-premise consumption "at home" and at "friends' houses" stand out as the two main preferences for drinking both pisco and all the other spirits.

⁸¹ EC First Submission, Table 13.

⁸² 1997 SM survey, p. iii and Section 4.3 (EC Exhibit 21).

Table 11⁸³

Drinking places

	Pisco	Whisky	Gin	Vodka	Tequila	Rum	Brandy
<u>Home</u>	72	65	57	53	51	67	75
<u>Friends' house</u>	60	58	62	55	67	61	56
<u>Restaurant</u>	31	18	13	16	14	9	13
<u>Disco</u>	20	19	26	35	28	23	14
<u>Pub</u>	20	16	30	42	31	18	12
<u>Bar</u>	12	9	1	22	14	21	5

Basis: % of consumers of each type of spirit

(iv) *Consumer profile*

4.109 According to the European Communities, Table 12 shows that both pisco and the other distilled spirits are widely consumed across all social and age segments.⁸⁴

⁸³ EC First Submission, Table 14.

⁸⁴ 1997 SM survey, p. iv (EC Exhibit 21).

Table 12⁸⁵

Consumer profile

	Socio-economic segment			Age			Gender		Total
	High	Middle	Low	20/34	35/44	45+	Male	Female	
<u>Pisco</u>	93	88	97	89	96	93	91	93	92
<u>Whisky</u>	66	55	39	51	46	54	56	44	51
<u>Tequila</u>	43	43	27	58	24	17	34	42	37
<u>Chilean Brandy</u>	7	17	30	19	16	25	21	19	20
<u>Liqueur</u>	15	15	20	19	11	18	11	25	17
<u>Vodka</u>	21	16	15	25	7	10	19	13	16
<u>Rum</u>	20	18	10	23	8	12	17	14	16
<u>Gin</u>	13	17	9	20	11	8	17	10	14
<u>Brandy</u>	1	3	2	4	-	3	3	2	3

Basis: % of consumers of each spirit

4.110 **In rebuttal, Chile points out** that with regard to end-uses of different spirits, Table 9 demonstrates significant differences in the way consumers use the products, most notably the totally different tendency of pisco and whisky drinkers to consume the respective products as mixed drinks.

4.111 Chile indicates that as to places of consumption and occasions for consumption, the survey shows little more than that most Chilean vodka drinkers have a markedly greater tendency to consume that product in discos and that Chileans generally prefer to consume all the different types of products with friends (except liqueurs, which inexplicably attract a less sociable Chilean consumer). Otherwise, this study has approximately the same probative value as if, in trying to decide whether meat and bread were directly competitive or substitutable, a study were produced demonstrating that both tended to be consumed at meal times (and with friends or family, Chile would guess).

4.112 Chile disagrees with the 1997 SM survey conclusion that "... pisco and other distilled spirits are drunk in the same styles, in the same occasions and places and by essentially the same categories of consumers". While it is not Chile's aim to rebut each one of these findings, Chile disagrees that these findings (even if they were true) are conclusive of "direct competition or substitutability" as required by GATT Article III:2, second sentence.

4.113 Chile argues that following the EC's reasoning, it must conclude that all type of food are directly competitive, because they are eaten basically by the same category of consumers (actually everybody has to eat), in the same occasions and places (home, friend's home, restaurants, etc) and is consumed in the same styles (cooked, raw, mixed with other food).

⁸⁵ EC First Submission, Table 15.

4.114 Chile further casts doubt on the conclusions drawn by the European Communities regarding drinking style. As it can be seen from Table 9, pisco is mostly drunk with a soft drink (83% of consumers) while whisky is mostly drunk "on the rocks" (75%); 31% of consumers drink pisco as a "sour drink", while the closer spirit would be tequila, with a mere 11% of its consumers. Table 9 shows that drinking styles are shared (actually it will be difficult to discover another drinking style), but nobody could draw the conclusion that all distilled spirits are similarly drunk.

4.115 **The European Communities contests** Chile's argument that, in any event, the responses to the EC consumer surveys "do not establish that the products are directly competitive or substitutable". For instance, contrary to the claims of Chile, Chilean vodka drinkers do not "have a markedly greater tendency to consume that product in discos". In fact, according to the 1997 SM survey, consumption of vodka at discos only comes fourth after consumption "at home", "at friends' places" and "at pubs".

4.116 In the view of the European Communities, the survey data concerning places of consumption are by no means irrelevant in order to establish substitutability. That type of information is regularly tracked by the spirits industry for marketing purposes. Further, the European Communities notes that Korea built its unsuccessful defence in the recent *Korea – Taxes on Alcoholic Beverages* case on the allegation that soju was drunk in different places than western spirits.

4.117 According to the European Communities, the fact that Chilean consumers prefer to drink spirits "with friends" is also far from irrelevant. This points to one of the specific uses which distinguish distilled spirits from other beverages: promoting socialisation. While many people prefer to drink spirits with friends, most people would answer that they drink water when they are thirsty and not when they are with friends.

(v) *Advertising*

4.118 **The European Communities points out** that when it markets its product, the pisco industry appears to entertain no doubts with respect to the substitutability of pisco with other distilled spirits. Quite to the contrary, pisco's promotional claims tend to emphasise the similarity of pisco with other distilled spirits, both in terms of physical characteristics and usage.

4.119 According to the European Communities, by way of example, Control's Internet homepage answers to the question "what is pisco?" with the following description of its characteristics:

Combine the dryness of Gin, the versatility of Vodka, the raciness of Rum and the bouquet of a delicate Cognac and you will discover the only distillation with this unique and aromatic result.⁸⁶

4.120 According to the European Communities, also in its Internet homepage, Control describes the end-uses of pisco as follows:

The distinct flavour and fresh aroma of Pisco control can be enjoyed by itself, on the rocks, with lemon or fruit juice, your favourite cocktail or mix as well as with popular soft drinks.⁸⁷

4.121 The European Communities points out that the versatility of pisco is also emphasised in the drink recipe brochures (*recetarios*) distributed by Control and Capel in Chile and abroad.⁸⁸ Those

⁸⁶ EC Exhibit 53. The European Communities notes that the same claim is made in Control's recipe brochure (EC Exhibit 51). It is worth noting that Control makes the same claim in the Spanish version of its home-page.

⁸⁷ EC Exhibit 53.

brochures promote the use of pisco in the same styles that are also characteristic of the other distilled spirits: straight, on the rocks, with lemon or fruit juice, or with cola or soda.

4.122 The European Communities further notes that the recipe brochures of both Capel and Control go as far as to recommend the use of pisco in place of other distilled spirits that are customarily used in well-known mixed drink recipes. Thus, for example, Capel suggests preparing "caipirinhas" with pisco instead of cachaca (so-called "pisquinhas"), Manhattans with pisco instead of whisky (so-called "Chilean Manhattan"), or "margaritas" with pisco instead of tequila. Similarly, Control's brochure provides recipes for preparing "pisco tonics" and "Control Manhattans".

4.123 **Chile challenges** the EC argument, saying that the European Communities also looks to the internet for examples of common styles of advertising. Ironically, the European Communities chooses to quote a pisco producer who concludes by calling pisco "the only distillation with this unique and aromatic result". If the European Communities will scan further in the Internet, Chile believes the European Communities will discover that everything a human being can ingest is advertised in rather similar terms on the internet.

4.124 **The European Communities further responds** that it has failed to find any Internet information showing that the Chilean farmers make advertising claims in the Internet comparing the "versatility" of milk to that of vodka or the "bouquet" of garlic to that of a "delicate Cognac".

(c) Tariff Classification

4.125 **The European Communities notes** that pisco and all the other distilled spirits fall within the same HS heading, namely HS 22.08.

4.126 The European Communities points out that non-alcoholic beverages, as well as alcoholic beverages obtained by fermentation such as beer or wine fall within other HS positions. As mentioned above, the characteristic of being a "distilled alcoholic beverage" is sufficient to establish that all spirits have common end-uses and, therefore, that they are "directly competitive or substitutable".

4.127 The European Communities further points out that within HS Chapter 22, HS 2208 is at the same level as the tariff positions for non-sweetened or flavoured water (HS 2201), flavoured or sweetened water (HS 2202), beer (HS 2203), wine (HS 2204) vermouth (HS 2205) and vinegar (HS 2209). Arguably, each of those products constitutes (at the very least) a single category of "directly competitive or substitutable products".

4.128 The European Communities explains that the sub-headings within HS 2208 correspond each to a well known type of spirit. The reason why specific sub-headings were created for those spirits, and not for the other spirits, was simply that brandy, whisky, gin, vodka, rum and liqueurs are the spirits which are internationally traded in largest volumes. Thus, in the 1996 HS a new tariff sub-heading was created for vodka, which previously had been classified into the residual "other" sub-heading, in recognition of the growing trade in that spirit.

4.129 **In rebuttal, Chile states** that it concedes the obvious point that all distilled spirits share a common tariff category, however, a point which is of virtually no legal significance. It is obvious that two products falling within the same four digit HS category are not necessarily "directly competitive

⁸⁸ EC Exhibits 50 and 51. The European Communities notes that the recipe brochures of Capel and Control are very similar to the promotional brochures published by the Scotch Whisky Association attached as EC Exhibit 55. According to the European Communities, that similarity constitutes a further indication of substitutability between pisco and whisky.

or substitutable" because applying this reasoning, oxygen and arsenic should be considered "substitutable" because both fall under HS 2804; the same could be said then to aviation gas and vaseline white oil (HS 2710); mackerel and caviar (HS 1604) lobster and crabmeat meal (HS 0306); and ivory and nails (HS 0507). Therefore this evidence should also be rejected.

(d) Channels of Distribution

4.130 **The European Communities notes** that Table 13 below sets out the findings of the 1997 SM survey⁸⁹ with respect to the availability of pisco and other distilled spirits in different sales channels. It shows that all different types of premises market both pisco and all the other spirits and that, for all of them, the preferred sales outlets are the same (supermarkets and liquor stores).

Table 13⁹⁰

Retail purchase outlets

	Pisco	Whisky	Liqueur	Brandy	Tequila	Gin	Rum	Vodka
<u>Super market</u>	61	65	61	47	50	58	46	47
<u>Liquor store</u>	41	26	32	39	40	43	34	43
<u>Gift shop</u>	3	8	6	9	5	7	6	-
<u>Duty free</u>	1	7	3	-	2	-	9	2
<u>Grocery</u>	4	1	-	5	4	-	-	3
<u>Air lines</u>	-	1	-	-	1	3	2	-
<u>Other</u>	3	6	9	-	8	-	8	7

Basis: % of consumers of each spirit

4.131 According to the European Communities, a further indication of substitutability between pisco and other distilled spirits is the similarity of their presentation in retail outlets. A selection of photographs taken from 6 retail outlets in Santiago in mid 1997⁹¹ evidence that pisco and other spirits are shown to consumers in the same shelf space areas. This shelving is responsive to the consumers' need to make choices among substitutable products.

4.132 **Chile points out** that as to distribution channels, the European Communities puts great weight on the tendency of supermarkets to show pisco on shelves near whisky and other distilled spirits. One might on that basis argue that toothpaste and soap are substitutable, because they share shelf space.

4.133 **The European Communities states** that it does not put "great weight" on the fact that Chilean supermarkets tend to show pisco on the same shelves as whisky and other distilled spirits. The European Communities referred to that tendency as an additional indication of competition,

⁸⁹ 1997 SM survey, p. iii and section 4.3 (EC Exhibit 21).

⁹⁰ EC First Submission, Table 16.

⁹¹ EC Exhibit 56.

among many other indications mentioned in its submission. For instance, the European Communities has produced detailed survey evidence showing commonality of distribution channels. The European Communities doubts that Chile would consider it irrelevant if whisky and pisco were generally sold at opposite corners of supermarkets. Finally, although toothpaste and soap may share shelf-space in some cramped night shop patronised by busy lawyers in Washington DC, they tend to be displayed separately in larger supermarkets.

4.134 **Chile contests** the EC statement that "evidence that two products are sold in the same channels can be taken as evidence that they are 'directly competitive and substitutable'." Common distributions channels are not strong evidence, and multipurpose channels are weaker still than dedicated channels, such as gas stations or pharmacies. Supermarkets are, by no means, a "dedicated channel", and finding that two products are sold mainly at supermarkets, doesn't prove anything about their competitiveness.

4.135 Chile further states that even if it considers dedicated distribution channels, like gas stations or pharmacies, it is hard to conclude that two products sold through those channels are substitutable. For instance, medicines sold only through pharmacies are usually non-substitutable, as are gas and lubricants sold primarily at gas stations.

4.136 In Chile's view, in the case of liquor stores, the only dedicated channel that could be considered, besides spirits, they sell wine, beer and soft drinks (snacks and some confectionery could also be added to this list).

4.137 Chile explains that it has requested AC Nielsen, a marketing research firm, to provide information on distribution channels employed in Chile by different type of food industries, pisco and whisky. The results are shown in Table 14 below.

Table 14⁹²

Distribution Channels

Product	Supermarket	Traditional
tea	76.6%	23.4%
tomato sauce	76.0%	24.9%
rice	83.1%	16.9%
pasta	76.7%	23.3%
hot pepper sauce	77.3%	22.7%
pisco	46.2%	53.8%
whisky	66.0%	33.3%

Source: AC Nielsen

4.138 Chile considers from these data that it can observe, that roughly 80% of tea, tomato sauce, rice, pasta and red pepper is sold in supermarkets, while the remainder is sold through what they call "traditional" channels. It is more than obvious that these products are not competitors or substitutable among themselves, yet they share basically the same distribution channel.

4.139 Chile further states that other important information provided by AC Nielsen, is that 46.2% of pisco is sold in supermarkets, while 53.8% is sold by the "traditional" channels. In the case of whisky, 66% is sold through supermarkets and only 33% through "traditional" channels. This is not surprising, because whisky is primarily consumed by the wealthier segment of population, while pisco is a more popular spirit.

⁹² Chile Oral Statement at the Second Substantive Meeting, Table IV.

4.140 According to Chile, comparing AC Nielsen's and Search Marketing's outcome results, one could question the accuracy of Search Marketing's findings, that tell us that 61% of pisco is sold through the supermarkets.

4.141 Chile indicates that it disagrees with the EC's point regarding supermarket shelving. Despite the EC's argument, the fact is that in Chilean Supermarkets lot of products that are, by no means, substitutable (as soap and toothpaste) share the same shelves.

(e) Price Differentials

4.142 **In rebuttal to the EC argument, Chile stresses** the price differentials between pisco and other distilled spirits using Table 15 below.

Table 15⁹³

Product	Duty Free Price US\$	Alcohol Content (°)	Chilean Custom Duties	Price including Chilean Duties US\$	New Chilean System	Price including new tax system US\$
1	2	3	4	5	6	7
Whisky J W Red	10.96	43	11%	12.17	47%	17.88
Whisky J W Black	24.11	43	11%	26.76	47%	39.34
Whisky J W Gold	52.00	43	11%	57.72	47%	84.85
Whisky J W Blue	144.00	43	11%	159.84	47%	234.96
Canadian Club	11.41	40	0%	11.41	47%	16.77
Jack Daniels	14.07	45	11%	15.62	47%	22.96
Tequila (Cuervo)	11.97	38	0%	11.97	39%	16.64
Grappa	10.80	40	11%	11.99	47%	17.62
Pisco Especial	2.86	35	11%	2.86	27%	3.63
Pisco Reservado	3.89	40	11%	3.89	47%	5.72

SOURCES: Pisco prices from Chilean Industries.
 Prices of other products, from Peter Justessen Catalogue, 1998 edition.
 Note: All prices are referred to 1 litre bottle.

4.143 Chile emphasises that pisco, in any of its different varieties, has a pre-tax price (i.e., duty free) that is substantially lower than that of whisky. As column five of Table 15 shows, whisky (at a price including Chilean custom duties of US\$12.17) is 3.1 times more expensive than a pisco of same alcohol strength (price of US\$ 3.89). The same column shows that when comparing whisky with Pisco Especial (35° strength) the price of the former is more than 4.2 times more expensive.

4.144 Chile further points out that the price difference between whisky and pisco of the same strength is not altered when comparing prices including the New Chilean System. Indeed, column seven of the chart, shows that the price of whisky (US\$ 17.88) remains 3.1 times more expensive than pisco of same strength (price US\$ 5.72). The price differential is so big that it is no wonder that consumers, particularly in a country of relatively low incomes, prefer low cost spirits.

4.145 **The European Communities responds** that Table 15 is incomplete and misleading. It compares the prices of a relatively expensive brand of whisky (Johnnie Walker) to what appears to be the price of a relatively inexpensive brand of pisco. Furthermore, the prices are at different levels of trade and, therefore, not comparable. The prices for whisky are retail prices (presumably in Chile), as

⁹³ Chile Oral Statement at the First Substantive Meeting, Annex I.

shown in the catalogue of a supplier of duty free goods to the diplomatic trade, and include not only freight and insurance but also what appears to be a rather substantial margin for the distributor. In contrast, the prices for pisco are producers' prices at ex factory level.

4.146 The European Communities argues that both pisco and the other spirits are sold within a wide range of prices. As shown in Table 16 below, the price differences within the category of pisco may be as large, both in absolute and in relative terms, as the price differences between pisco and whisky shown in Chile's table. The European Communities claims that Chile does not appear to contest that all types and brands of pisco constitute a single product and compete with one another.

Table 16⁹⁴

Retail prices of pisco, February 1997

<u>Brand</u>	<u>Price (pesos)</u>	<u>Price difference index</u>
Valle del Limarí 30 %	869	1
Capel 30 %	999	1.15
Tres Erres 32 %	1,459	1.69
Bauza 30 %	2,468	2.84
Control 35 %	1,295	1.49
Capel 35%	1,458	1.68
Control de Guarda 35 %	2,389	2.75
Alto del Carmen 35 %	2,458	2.83
Bauza 35 %	2,480	2.85
Control 40 %	1,519	1.75
Capel 40 %	1,588	1.83
Control de Guarda 40 %	2,699	3.11
Alto del Carmen 40 %	2,998	3.45
Bauza 43 %	3,628	4.17
Alto del Carmen 46 %	3,798	4.37
Chenaral 46 %	4,790	5.51

Source: ISWR Report, EC Exhibit 19, pp. 80-81

4.147 The European Communities further argues that pisco is not less expensive than other spirits. Table 17 below evidences that, despite the price distortions caused by the differences in taxation, the

⁹⁴ EC Response to Questions asked at the First Substantive Meeting, Table 1.

prices (tax included) of pisco overlap with the prices (tax included) of other types of spirits (including whisky) which are more heavily taxed.

Table 17⁹⁵

Range of retail prices (including tax), February 1997

<u>Spirit</u>	<u>Lowest price (pesos)</u>	<u>Highest price (pesos)</u>
Pisco	869	4,790
Gin	2,175	5,580
Vodka	2,545	8,050
Rum	1,490	6,838
Brandy	1,375	114,900
Tequila	3,180	5,4901
Whisky	3,550	34,690

Source: ISWR Report, EC Exhibit 19, pp. 53-54, 58, 62, 65, 70, 75-76, 80-81

4.148 The European Communities also argues that in any event, a comparison of absolute price differences is of limited value in order to establish whether two products are actually competing on a given market. Basic economic theory tell us that it is more relevant to look at the response of consumers to changes in the relative prices of the products, i.e., to their rate of cross-price elasticity.⁹⁶ The European Communities claims that it has provided to the Panel ample evidence (including two studies commissioned by the pisco industry itself) showing that there is a significant degree of cross-price elasticity between pisco and the other spirits and, therefore, that they are directly competitive or substitutable.

4.149 The European Communities adds that in the present case, absolute price differences are even less relevant in view of the nature of the products concerned. Distilled spirits are consumer goods which have a small value relative to income and are purchased many times over a short period of time. This means that, even if one spirit was much more expensive than the other, a relatively small decrease in the price of the more expensive one could be sufficient for consumers to increase the number of occasions in which they drink that spirit instead of the less expensive one.⁹⁷

4.150 The European Communities further alleges that absolute price differences can be the consequence of the measures in dispute. A comparison of pre-tax prices is not sufficient to remove all the distortions which a protective system of taxation may have caused over a long period of time. For example, one of the effects of a protective system of taxation may be to favour the sale of premium brands of imported spirits over less expensive brands. Also, protective taxes limit the sales growth of the imported spirits and keep their selling and distribution expenses at an artificially high level as compared to domestic products sold in larger volumes.⁹⁸

⁹⁵ EC Response to Questions asked at the First Substantive Meeting, Table 2.

⁹⁶ Panel Report on *Korea - Taxes on Alcoholic Beverages*, *supra.*, para. 10.94.

⁹⁷ *See ibid.*, paras. 10.74 and 10.91.

⁹⁸ *Ibid.*, para. 10.93 and fn. 410.

4.151 The European Communities finally recalled that absolute price differences can be the consequence of conjunctural factors such as movements in the exchange rates.⁹⁹

4.152 **In response, Chile explains** that its intention in providing Table 15 above was twofold: (1) to illustrate for the Panel the significant price difference between pisco and whisky; and (2) to illustrate for the Panel the disproportionately greater burden imposed on a low-priced product by the use of a specific tax (in this case the tax levied by some EC countries on alcohol), measured in *ad valorem* terms.

4.153 Chile considers that the most accurate basis for comparing the prices in Chile of pisco and whisky should be between ex-factory price of pisco, and the *after customs duty* price of whisky (CIF + import duties) in Chile. That comparison excludes any mark-up in the distribution channel.

4.154 Chile adds that the ex-factory prices of pisco are, on average, US\$ 2.60 for pisco of 30° to 35°, and US\$ 3.60 for pisco of 40° to 46°. For imported whisky the average CIF price, in 1997, according to Central Bank of Chile statistics, was US\$ 5.55. Adding an 11% *ad valorem* import duty, the average *after customs* price of whisky was US\$ 6.16.

4.155 Chile goes on to argue that these price differences between whisky and pisco are thus very significant, almost double between whisky and high alcohol pisco, and more than double between whisky and low alcohol pisco.

4.156 Further, Chile points out that it is unlikely that these prices are distorted by levels of trade in any material way. While much more pisco than whisky is sold in Chile, whisky is still imported in substantial quantities. Further, far more whisky than pisco is produced in the world, and that ample production would presumably allow superior economies of scale for whisky.

4.157 Also, in Chile's view, the European Communities also affirms that "Distilled spirits are consumer goods which have a small value relative to income ..." and interprets this to mean that "even if one spirit was much more expensive than the other, a relatively small decrease in price of the more expensive one could be sufficient for consumers to increase the number of occasions in which they drink this spirit instead of the less expensive one". This is highly speculative on the part of the European Communities and thus far remains unproven.

4.158 Further, Chile contests the EC statement with respect to "... the distortions which a protective system of taxation may have caused over a long period of time. For example, one of the effects of a protective system of taxation maybe to favour the sale of premium brands of imported spirits over less expensive brands". First, the effects of a repealed system are not relevant. Second, because even the previous Chilean tax system operated on an *ad valorem* bases, there was no distortion in favor of more expensive brands.

4.159 Finally, Chile disagrees with the EC's table of retail prices of pisco, which purports to show an overlap between pisco and whisky. Chile argues that this is misleading, and points out that the table does not reflect the fact that most pisco sold in Chile has a price of less than 3,000 pesos. In fact, there is very little overlap except for premium piscos, which will also generally be taxed at the same rate as whisky when the New Chilean System takes effect in December of 2000.

⁹⁹ Ibid., fn. 410.

(f) Cross-Price Elasticity

(i) *Market developments*

4.160 **The European Communities alleges** that sales of pisco have consistently tracked changes in factors that have a direct impact on the prices of other spirits (and in particular of whisky) but not on the prices of pisco itself, such as changes in the ILA rates applied to those spirits, changes in the level of the import duties on distilled spirits and fluctuations of the exchange rate between the Chilean peso and the US dollar. This evidences that the demand for pisco is responsive to changes in the prices of the other spirits and, therefore, that they are directly competitive or substitutable products.

4.161 According to the European Communities, the Chilean spirits market is largely dominated by pisco. As set out in Table 18 below, in 1996 sales of pisco accounted for as much as 74 % of the total quantity sold in that market. The same table shows that sales of pisco have increased considerably (by more than 400 %) since the early 1980s.¹⁰⁰

¹⁰⁰ The European Communities also refers to IWSR Report, p. 77, Table A (EC Exhibit 19).

Table 18¹⁰¹

Chilean spirits market 1982 – 1996: sales (thousands of litre) and market share*

	<u>1982</u>	<u>1984</u>	<u>1986</u>	<u>1988</u>	<u>1990</u>	<u>1992</u>	<u>1994</u>	<u>1996</u>
Pisco								
Sales	1,100.00	1,600.00	2,075.00	2,650.00	3,190.00	3,675.00	4,347.00	4,501.00
Share	44.1 %	59.0 %	68.8 %	70.4 %	72.5 %	70.6 %	72.9 %	73.8 %
Whisky								
Sales	497.00	258.00	223.50	249.00	224.50	224.50	249.50	264.00
Share	19.9 %	9.5 %	7.2 %	6.6 %	5.1 %	4.3 %	4.2 %	4.3 %
Vodka								
Sales	48.00	52.00	52.00	52.00	54.00	65.00	79.00	93.00
Share	1.9 %	1.9 %	1.7 %	1.4 %	1.2 %	1.2 %	1.3 %	1.5 %
Gin								
Sales	55.00	59.00	56.00	55.00	56.00	63.50	70.00	56.50
Share	2.2 %	2.2 %	1.8 %	1.5 %	1.3 %	1.2 %	1.2 %	0.9 %
Rum								
Sales**	54.00	50.00	48.50	53.00	61.75	80.50	99.50	101.00
Share**	2.2 %	1.8 %	1.8 %	1.4 %	1.4 %	1.5 %	1.7 %	1.7 %
Brandy								
Sales	55.00	80.00	130.50	164.00	209.00	265.25	289.25	194.50
Share	2.2 %	2.9 %	4.2 %	4.4 %	4.7 %	5.1 %	4.8 %	3.2 %
Tequila								
Sales	1.00	Nil	0.25	1.25	3.75	14.00	32.50	72.50
Share	0.0 %		0.0 %	0.0 %	0.1 %	0.3 %	0.5 %	1.2 %
Liqueur								
Sales***	347.00	318.50	291.50	249.50	262.25	260.00	245.50	230.00
Share***	13.9 %	11.7 %	9.4 %	6.6 %	5.7 %	5.0 %	4.1 %	3.8 %
Other								
Sales	340.00	295.00	230.00	290.00	340.00	560.00	555.00	585.00
Share	13.6 %	10.9 %	7.4 %	7.7 %	7.7 %	10.75 %	9.3 %	9.6 %
Total	2,497.00	2,712.50	3,107.25	3,763.25	4,401.25	5,207.75	5,967.25	6,097.50

* Source: ISWR report (EC Exhibit 19)

** Includes cachaca

*** Includes liqueurs, bitters, aperitifs, aniseed and fruit eaux de vie

4.162 The European Communities notes that all pisco sold in Chile is, by definition, produced domestically. Imports of pisco from Peru and other sources (which must be sold as *aguardiente*) are marginal.¹⁰²

¹⁰¹ EC First Submission, Table 9A.

¹⁰² IWSR Report, p. 78, Table C.1 (EC Exhibit 19).

4.163 The European Communities further states that whisky is the best selling spirit after pisco. As shown in Table 18 above, in 1996 sales of whisky accounted for 4.3 % of the spirits market. Domestic production of whisky is negligible.¹⁰³ It can be estimated that imports represent approximately 94 % of total sales of whisky.¹⁰⁴ In turn, Scotch whisky accounts for 95 % of all imports.¹⁰⁵

4.164 The European Communities also notes that until the mid-1970's, imports of whisky remained very small. Thus, in 1975 imports of Scotch whisky amounted to barely 165 thousand litres, based on UK Customs and Excise Export Statistics.¹⁰⁶ During the second half of the 1970s, imports of whisky grew spectacularly. As of 1981, when they peaked, sales of Scotch whisky had reached a volume of 5.9 million litres.¹⁰⁷ This increase was the result of a combination of factors. In the first place, the progressive reduction of import tariffs from 80 % at the beginning of 1976 to 10 % as of May 1979.¹⁰⁸ Second, a parallel reduction in the ILA from 40 % plus the *recargo* in 1974 to 30 % in 1977, i.e., only 5 percentage points more than the rate on pisco, as Table 6 above. Finally, imports of whisky benefited from a rapidly expanding economy with very high growth rates as well as, between 1979 and 1981, from a strong peso pegged to the US dollar.¹⁰⁹

4.165 The European Communities further asserts that during the first half of the 1980s this trend suffered a dramatic reversal. In 1982, the Chilean economy entered into a deep recession¹¹⁰ and the peso underwent the first of a series of devaluations.¹¹¹ Import duties on distilled spirits were increased from 10 % to 20 % in 1983 and again to 35 % the following year.¹¹² Last but not least, the ILA rate on whisky was raised to 50 % in 1983, to 55 % in 1984 and to 70 % in 1985, thus increasing the tax differential between pisco and whisky from 5 to 45 percentage points in less than two years, as shown in Table 6 above. The imposition of higher taxes and import duties, allied to the new macro-economic environment, had a devastating effect: sales of Scotch whisky dropped from 5.9 million litres in 1981¹¹³ to just under 1.3 million litres in 1985¹¹⁴, i.e., by nearly 80 %.

4.166 According to the European Communities, Chile emerged from the recession in 1987¹¹⁵ and import duties were lowered to 11 % as of 1991.¹¹⁶ But the remaining tax differential, together with the market dominance gained by pisco in the meantime, have so far prevented whisky from recovering its former position. By 1996 sales of whisky still represented merely 39 % of the volume sold in 1981¹¹⁷, and this despite a considerable increase in the overall demand for spirits. As a result, as set out in Table 18 above, the market share of whisky shrank from 20 % in 1982 to just 4 % in 1996.

4.167 Further, the European Communities states that meanwhile, pisco sales have consistently moved in the opposite direction. Between 1976 and 1981, pisco suffered from the spectacular increase in whisky imports. Although sales of pisco continued to grow in absolute terms, they did so

¹⁰³ IWSR Report, p. 43, Tables A and A.1 (EC Exhibit 19).

¹⁰⁴ Ibid.

¹⁰⁵ Ibid.

¹⁰⁶ EC Exhibit 57.

¹⁰⁷ IWSR Report, at p. 43, Table A. (EC Exhibit 19).

¹⁰⁸ EC Exhibit 57.

¹⁰⁹ EC Exhibit 61.

¹¹⁰ The European Communities refers to EC Exhibit 58, and also to the IWSR report, p. 6 (EC Exhibit 19).

¹¹¹ The European Communities refers to EC Exhibit 61.

¹¹² EC Exhibit 57.

¹¹³ IWSR Report, page 43, table A (EC Exhibit 19).

¹¹⁴ Ibid.

¹¹⁵ EC Exhibit 60.

¹¹⁶ EC Exhibit 57.

¹¹⁷ IWSR Report, page 43, table A (EC Exhibit 19).

at a much lower rate than the sales of whisky.¹¹⁸ In 1982, when Chile was hit by recession, sales of pisco fell by 20 %.¹¹⁹ In reaction to this, the pisco industry stepped up the pressure to obtain additional protection against imports of whisky. As explained above, the Chilean authorities responded to those demands with a series of successive increases in the import duties and in the ILA rates on whisky. These measures proved highly effective. While sales of whisky continued to decline until 1986 and stayed relatively flat thereafter¹²⁰, sales of pisco began to increase again in 1983 and by 1984 had already exceeded their 1981 level.¹²¹ Furthermore, the additional protection afforded by the increase in tariffs and taxes on whisky allowed the pisco industry to capture most of the growth of the spirits market that took place during the following decade as the Chilean economy resumed its rapid expansion. As a result, the market share of pisco increased from 44 % in 1982 to 74 % in 1996, as shown in Table 18 above.

4.168 Referring to these tables, the European Communities further notes that liqueurs are the third largest type of spirits in terms of sales volume, with approximately 4 % of the market. Most liqueurs sold in Chile have a relatively low alcohol content. As shown in Table 5 above, all liqueurs (with the only exception of anisettes) have a legal minimum strength below 35°. Imports represent less than 10 % of total sales. Together, vodka, gin and rum hold a further 4 % of the market. Imports account for a substantial proportion of their sales: 36% of gin, 41 % of vodka and 55 % of rum. Despite the considerable overall increase in demand for spirits, sales of these three types of spirits have grown only moderately, with the consequence that they have all lost market share since the early 1980's, as shown in Table 18 above.

4.169 The European Communities states that tequila entered into the Chilean market at the beginning of the 1990's. Although it has enjoyed a considerable success, especially among young consumers, it still represents under 2 % of the market. All sales of tequila are imported from Mexico, as shown in Table 19 below.

¹¹⁸ The European Communities refers to IWSR Report, p. 77, Table A (EC Exhibit 19), and for the period before 1980, to EC Exhibit 59.

¹¹⁹ IWSR Report, page 77, table A (EC Exhibit 19).

¹²⁰ IWSR Report, page 43, table A (EC Exhibit 19).

¹²¹ IWSR Report, p. 77, table A (EC Exhibit 19).

Table 19¹²²

Sales of domestic spirits v. imports in 1996 (000 9 litre cases)*

	<u>Domestic</u>	%	<u>Imported</u>	%
Pisco	4,501.00	100	Nil	0
Whisky	17.00	6.4	247.00	93.6
Vodka	55.00	59.1	38.00	40.9
Gin	36.00	63.7	20.50	36.3
Rum**	45.00	44.6	56.00	55.4
Brandy	190.00	97.7	4.50	2.3
Liqueur***	208.50	91.0	20.5	9.0
Tequila	Nil	0	72.5	100
Other	585.00	100	Min	0
Total	5,637.5	92.5	459.00	7.5

* Source: ISWR report (EC Exhibit 19)

** Includes cachaca

*** Includes liqueurs, bitters, aperitifs, aniseed and fruit eaux de vie

4.170 According to the European Communities, brandy accounts for approximately 3 % of the spirits market. Domestic production represent nearly 98 % of the sales. The vast majority of domestic sales are of the brand "Tres Palos", with an alcohol content of 38°.

4.171 The European Communities concludes that, as already explained, the sales and market share of pisco have consistently tracked changes in factors that have a direct impact on the prices of the other spirits, but not on the prices of pisco itself. Those changes include not only the changes in internal taxation, but also changes in import duty rates and exchange rate fluctuations between the Chilean Peso and the US dollar. This evidences that the demand for pisco is responsive to changes in the prices of other spirits and, therefore, that they are directly competitive or substitutable.

4.172 The European Communities adds that the correspondence between the sales/market share of pisco and the prices movements of the other spirits is particularly noticeable during the period 1982 - 1986, where the changes in the prices of the other spirits were most dramatic (The European Communities claims that a large portion of that period is not covered by the regression provided by Chile).

4.173 The European Communities also explains that the correspondence is more easily observable in the case of whisky than in the case of "other spirits". Several reasons may account for this. In the first place, the tax increases were larger in the case of whisky. Second, "other spirits" started from a

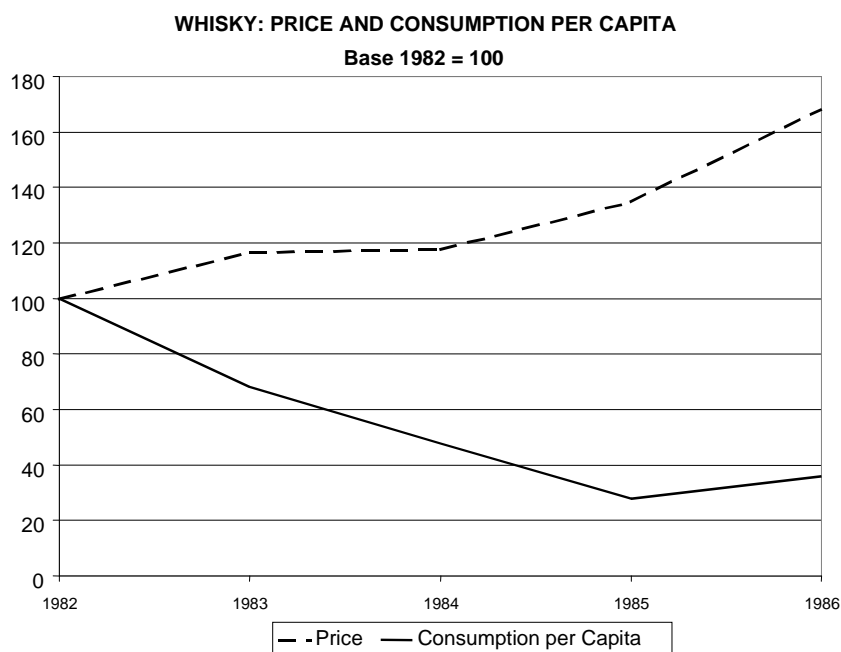
¹²² EC First Submission, Table 9B.

smaller base than whisky. In relative terms, however, the loss of market share experienced by "other spirits" is far from negligible. Gin and rum, for instance, suffered an 18 % share loss between 1982 and 1986. Finally, "other spirits" include a larger share of domestic production, which was not affected by changes in import duties and exchange rates.

4.174 **In rebuttal, Chile contends** that it should be noted that Table 18 is not based on any official statistics. Further, the European Communities with this chart attempts to prove that products are directly competitive or substitutable by assuming that they are directly competitive or substitutable, since the EC chart assumes a single market composed of the sum of the sales of each different distilled spirit. Thus, the EC's economic logic is highly faulty.

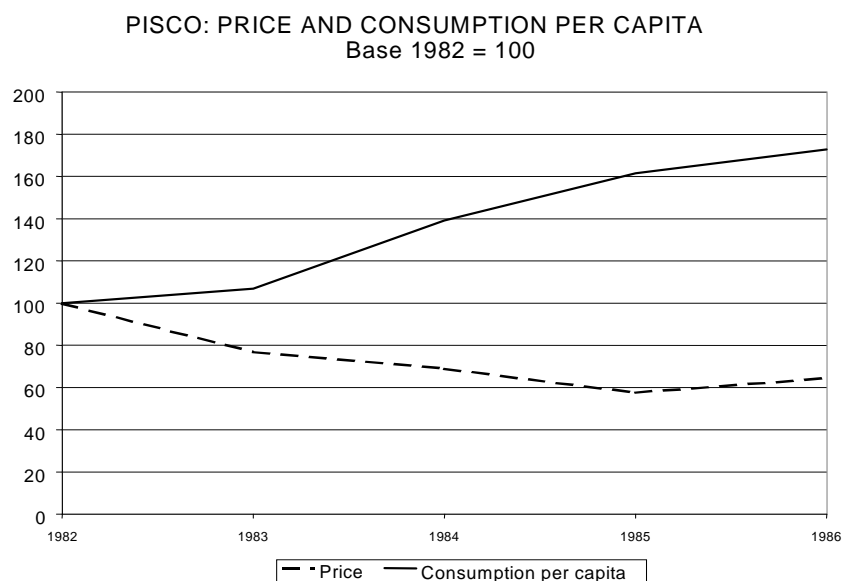
4.175 Chile analyses the evolution of the consumption of whisky and pisco on the basis of the data provided by the European Communities. Chart 1 below shows for whisky the changes in per capita consumption and prices during the period 1982-1986. As can be seen, during this period the price of whisky in real terms, that is, adjusted for internal inflation, rose 67%. Per capita consumption of whisky in this same period fell by 64%. No one should be surprised that consumption of a product fell as its price rose in this fashion.

Chart 1



4.176 According to Chile, Chart 2 shows the changes in price and per capita consumption of pisco during the same period 1982-1986. As can be seen, during this period the price of pisco in real terms fell by 35% and consumption per capita rose 69%. It is similarly not surprising that a product whose price significantly declines, increases in consumption.

Chart 2



4.177 In Chile's view, the increase in the price of whisky during the period in question, is a result of three principal factors: the depreciation of the Chilean currency, the increase of tariffs and the increase of the tax on whisky. It analysed each factor independently:

- (i) Depreciation of the Chilean currency: During the period from 1979 to 1982, the Chilean peso maintained a stable relation with the dollar (Ch\$ 39 = US \$1). As a result the crisis of the balance of payments and other macro-economic factors, the Chilean peso fell 88% between mid 1982 (when the first series of declines occurred) and the end of 1986.
- (ii) Increase of tariffs: In 1982, the import tariff on whisky was 10 percent. The tariffs increased to 20 % in 1983, 35 % in 1984 and then were reduced to 20 % in 1985. In short, between the year of 1982 and 1986, there was a net increase in tariffs that increased the final price of the imported products by 9.09 %.
- (iii) Increase in the taxes on liquor: In 1982 the tax that applied to whisky was at a rate of 30 %. These rates increased to 50 % in 1983, 55 % in 1984 and 70 % in 1985. In short, the effect of the increase in taxes on whisky in the period of 1982 to 1986 was to increase the price to the consumer by 30.8 percent.

4.178 Chile argues that taking into account of all these elements already indicated, there was an increase in the price of whisky - *ceteris paribus* - of 168 percent, most of which was caused by factors having nothing to do with the increase in the tax on whisky. As it could be seen, not all of this increase was transferred to consumer prices. This suggests a diminution of margins, an increase in the local production of whisky and an increase in lower priced imported whisky, or some sort of a combinations of these factors. In addition, the price of pisco in Chile fell considerably, even though the tax on pisco did not change during the period in question.

4.179 Chile adds that as to other types of distilled spirits, it is not in a position to provide a similarly detailed assessment because of the wide variety of domestic and imported spirits included in that

category. However, as in the case of whisky and pisco, it would not be valid to assume that sales of this array of domestic and imported products held a relatively steady share of a hypothetical "distilled spirits" market because the tax remained steady. Within that group, Chile can imagine that there would have been a wide range of price effects, on individual types of domestic and imported spirits.

4.180 Chile also contests the EC statement that the period from 1982 to 1986 was not covered in the regression study of Chile. Chile included in its regression study the period from 1983 to 1997, thereby taking into account almost all the period of time in question. By contrast, the EC's study covered a shorter period and the European Communities has presented only partial results of that study.

4.181 Chile further notes that the European Communities states that "the sales and market share of pisco have consistently tracked changes in factors that have a direct impact on the prices of the other spirits, but not on the prices of pisco itself ... This evidences that the demand for pisco is responsive to changes in the prices of the other spirits ..." The European Communities erroneously implies that the changes in the sales of pisco would be exclusively explained by the changes in such factors and their effects on the prices of the other spirits, and not because of changes in the price of pisco. The reasoning followed by the European Communities underestimates a fundamental aspect: if the price of a good diminishes, the demanded quantity of that good increases (unless the demand for the good is inelastic, which means *inter alia* that is a good with no substitutes). The relation between the price and sales of pisco is enough in order to explain the changes in the sales of pisco. As can be observed in the results of the regression submitted by Chile, the relation between the price of the other spirits (whisky) and the sales of pisco is very low and statistically not significant; therefore, this relation can not explain by itself the changes alluded to.

4.182 Chile further notes that it produces more than 70 percent of the distilled spirits that are subject to the highest tax under the New Chilean System, including whisky.

4.183 **The European Communities disagrees with** Chile's claim that the increase in consumption of pisco between 1982 and 1986 was due to the decrease of the real price of pisco and not to the increase in the price of whisky. The reduction of pisco's real price may have contributed to the increase in pisco consumption, but was not the only cause. According to Chile's own data, between 1984 and 1986, the real price of pisco remained virtually constant. Yet, consumption per capita of pisco rose by 24 %. During the same period, the real price of whisky increased by 42 % and consumption per capita fell by 25 %.

4.184 The European Communities contests Chile's argument that "[i]n short, the effect of the increase in taxes on whisky in the period of 1982 to 1986 was to increase the price to the consumer by 30.8 percent". As the tax rate increased, the tax base increased too, due to the depreciation of the peso and the increase of tariffs. As a result, the effect of the tax increase in the final price of whisky was much more substantial. Thus, in the following table, the tax increase has the effect of increasing the final price of whisky by 286 %:

	1982	1986
Price in US\$	5	5
Price in Ch\$	195	1,025
Import duty	19.5	205
Tax	64.35	861
Retail Price	278.85	2,091

Contrary to Chile's claims, the tax increase accounts for the largest portion of the price increase (44 %).

4.185 **Chile further responds** that the math used by the European Communities to demonstrate the effect of taxation in the price of whisky is misleading. Chile disagrees not only with the mathematics, but also with the EC's conclusions drawn from that exercise. These conclusions show, at least, a lack of understanding of *ad valorem* taxation systems. To demonstrate its point, in Table 20 below, Chile presents an exercise, based in the EC's data in which the tax rate is maintained at a flat level of 30 % throughout the period. In this case, tax per unit of whisky will rise from Ch\$64.35 to Ch\$369, and the total price of whisky will rise from Ch\$278.85 to Ch\$1,599. According to EC's argumentation, this means that taxation has an effect of raising the price by 109% (even without changing the tax rate). What really happens, is that the tax base, rose by 473%, and therefore, tax levied on an *ad valorem* base varies accordingly.

Table 20¹²³

Tax effect with a 30% <i>ad valorem</i> rate			
	1982	1986	% Ch.
Price in US\$	5	5	0%
Price in Ch\$	195	1,025	425.6%
Import duty	19.5	205	951.3%
Pre-Tax Price	214.5	1,230	473.4%
Tax (30%)	64.35	369	473.4%
Retail Price	278.85	1,599	473.4%

(ii) *The 1998 Search Marketing survey*

4.186 **The European Communities further claims** that another consumer survey performed by Search Marketing S.A. at the request of the EC spirits industry (the "1998 SM survey")¹²⁴ further supports a finding that pisco and all other distilled spirits are directly competitive and substitutable.

4.187 According to the European Communities, the surveyors asked two questions to a representative sample comprising over 400 consumers who had purchased both pisco and at least one other spirit during the last six months.

4.188 The European Communities explains that the purpose of the first question was to measure the substitutability between pisco and other distilled spirits under current taxation and pricing conditions. To that effect, the question was drafted in the following terms: "if you wanted to buy a bottle of pisco, but pisco was not available, what of the following beverages would you buy instead?". Possible answers included, in addition to other types of distilled spirits, wine, beer, non-alcoholic beverages and "nothing". The same question was then repeated for each of the other types of distilled spirits covered by the survey.

4.189 The European Communities notes that Table 21 below summarises the answers given by the respondents in the situation where they wanted to buy pisco but that spirit was not available. It

¹²³ Chile Oral Statement at the Second Substantive Meeting, Table II.

¹²⁴ EC Exhibit 22.

indicates that a large majority of consumers regard other distilled spirits as the closest substitute for pisco.

Table 21¹²⁵

Response to the Question: "What would you buy if pisco was not available?"

Other spirits	70 %
Wine/Beer	17 %
Non alcoholic beverages	0 %
Nothing	13 %

4.190 The European Communities points out that in *Japan – Taxes on Alcoholic Beverages II*, Japan submitted a consumer survey showing that, in case of unavailability of shochu, "only" 10 % of consumers would switch to whisky and other spirits, whereas the remaining 90 % would turn to beer or other beverages. The panel was of the view that a 10 % switch was "proof of significant elasticity of substitution" between shochu and other spirits.¹²⁶

4.191 In the view of the European Communities, equally significant, as shown in Table 22 below, pisco was mentioned as the main alternative to each of the other spirits covered by the survey in the hypotheses where those spirits were not available.

Table 22¹²⁷

Response to the Question: "What would you buy if [whisky/tequila/brandy/rum/vodka/gin] was not available?"

	Whisky	Tequila	Brandy	Rum	Vodka	Gin
Pisco	50 %	56 %	52 %	43 %	48 %	45 %
Other spirits	25 %	17 %	15 %	19 %	21 %	19 %
Wine/beer	3 %	2 %	2 %	2 %	2 %	2 %
Non alcoholic beverages	0 %	0 %	0 %	0 %	0 %	0 %
Nothing	22 %	25 %	31 %	36 %	29 %	34 %

Basis: % of all respondents

4.192 The European Communities further explains that the second question asked by the surveyors aimed to measure the respondents' reaction to changes in the relative price of pisco and the other distilled spirits. Respondents were initially asked to make purchase choices between all products at current prices.¹²⁸ They were then shown an estimate of the prices that would prevail if all distilled

¹²⁵ EC First Submission, Table 17.

¹²⁶ Panel Report on *Japan - Taxes on Alcoholic Beverages II*, *supra.*, para 6.31.

¹²⁷ EC First Submission, Table 18.

¹²⁸ EC Exhibit 23.

spirits were taxed at the rate of 27 % *ad valorem* (i.e., the rate that will apply to most pisco as from 1 December 2000), and asked to make a choice at those prices. For these purposes, it was estimated that the envisaged tax change would bring about an increase in the prices of pisco of 1.7 % and a simultaneous reduction in the prices of whisky and of "other spirits" of 25.3 % and 2.3 %, respectively.

4.193 According to the European Communities, the responses to this second question indicate the existence of a significant degree of cross-price elasticity between pisco and other spirits. As shown in Table 23, the share of respondents choosing whisky and other spirits instead of pisco would increase from 17.7 % to 30.5 %, i.e., by as much as 72 %. The increase is particularly large in the case of whisky, which would benefit from the largest price reduction in the event that all spirits were taxed at 27 %. The share increase is also substantial, even if less marked, in the case of "other spirits", which would benefit from a smaller price reduction than whisky. Finally, it is worth noting that the increase in the share of whisky and "other spirits" takes place at the expense of all the categories of pisco, thus refuting any possible claims to the effect that whisky and "other spirits" compete only with certain types of pisco.

Table 23¹²⁹

	<u>At current prices</u>	<u>At prices with 27 % tax</u>	<u>Variation (%)</u>
Pisco tradicional	12 %	9.7 %	- 19.2 %
Pisco especial	47.2 %	42.3 %	- 10.4 %
Pisco reservado + Gran pisco	23 %	17.5 %	- 23.9 %
Whisky	6.3 %	14.1 %	+ 124 %
Other spirits	11.5 %	16.4 %	+ 43 %

4.194 The European Communities alleges that the 1998 SM survey can show only the immediate reaction of consumers to price changes. Yet, as discussed above, the consumption of distilled spirits is based on habits, which only change gradually. As a result, short-run elasticities of substitution between distilled spirits are, as a general rule, much lower than long-run elasticities. This means that, over a certain period of time, the price changes resulting from the elimination of tax differentials are likely to lead to a shift in consumption from pisco to other spirits even larger than that shown in Table 23 above.

4.195 **In rebuttal, Chile argues** that given the weakness of a complaint based on cross-price elasticity (as noted in paragraph 4.[219] below, a low coefficient of 0.26 was computed as cross-price elasticity for pisco and whisky), the European Communities tries to bolster its argument with an assortment of information based on a survey of 400 "representative" Chilean consumers. The EC survey does not logically make the case that pisco is directly competitive or substitutable with other spirits.

4.196 Chile further argues that the European Communities also attempts to use marketing surveys as a kind of substitute for econometric analysis. Specifically, the European Communities refers to

¹²⁹ EC First Submission, Table 19 (p. 60).

marketing surveys in which various consumers were asked what they would buy if there were no pisco and how they would react based on assumed increases in pisco prices accompanied by decreases in whisky prices. Such surveys are inherently much less reliable than an econometric analysis based on 15 years of data. Further, even the responses the European Communities received do not establish a directly competitive or substitutable relationship.

4.197 **The European Communities responds** that Chile seeks to discredit the consumer surveys submitted by the European Communities, but fails to advance any specific ground to cast doubt on the reliability of those surveys. Thus, for example, Chile appears to consider that it is sufficient to describe the sample of one of those surveys as being composed of 400 "representative" Chilean consumers in order to dispose *ipso facto* of that survey. The European Communities asks whether and why Chile is suggesting that the sample was not statistically representative.

4.198 The European Communities further notes that Chile argues that consumer surveys are "inherently much less reliable" than econometric studies. Previous panels, however, have not hesitated to rely upon the findings of consumer surveys in order to establish that products were "directly competitive or substitutable". In *Japan – Taxes on Alcoholic Beverages II*, the panel discarded a flawed regression submitted by Japan in favour of a much more robust consumer survey presented by the complainants.¹³⁰

4.199 **Chile further responds** that the last "evidence" provided by the European Communities, to support the idea that there is a significant cross-price elasticity between pisco and other distilled spirits, are the results of another survey conducted by Search Marketing, which is extremely weak.

4.200 Chile notes that the first piece of evidence cited by the European Communities, is the answer made by consumers to the question "what would you buy if pisco is not available". The conclusions to be drawn from this kind of question are highly questionable, because, as any marketing survey expert could tell, people facing situations that are not "normal" in their mind, tend to react in different and unpredictable ways. Also, without a very well designed system to avoid inconsistent answers (and the evidence provided by the European Communities does not lead to a conclusion as to whether those measures have been taken or not) the results are of very little significance. Last – but not least – the question was designed to actually "force" respondents to buy something else, or buy nothing, but would not provide one of the most logical alternatives "I will buy (pisco, whisky, gin, etc.) in another store".

4.201 Chile further points out that the other piece of the Survey is a "quantitative" analysis, in which the consumers, faced with a change in the prices of pisco, whisky and other liquors, show their preferences in the new situation (Table 23). A detailed analysis of this shows the inconsistency of the results, because they don't resist any serious analysis and, therefore must be discarded as evidence.

4.202 Chile also argues that in fact, Table 24¹³¹ shows that if the price of pisco increases 1.7%, the price of whisky is reduced by 25.3% and the price of "other spirits" by 2.3%, then the consumption of pisco will decrease by 15.5%, the consumption of whisky will increase by 123.8% and the consumption of other spirits by 42.6%.

¹³⁰ The European Communities refers to Panel Report on *Japan - Taxes on Alcoholic Beverages II*, *supra.*, paras. 6.28-6.32. According to the European Communities, Japan's regression had similar methodological problems to those of Chile's regression analysis.

¹³¹ According to Chile, Table 24 is elaborated from data submitted by the European Communities.

Table 24¹³²

Substitution Elasticity

	PRICE CHANGE	DEMAND CHANGE
PISCO	+ 1.7 %	- 15.5 %
WHISKY	- 25.5 %	+123.8 %
OTHERS	-2.3 %	+42.6 %

4.203 Chile comments that some basic microeconomic discussion must be added here, in order to make its points clear. It discussed the relationship between price elasticity (that is, how much the price of the good itself influences the quantity sold of that good) and cross-price elasticity, that means, how much the price variation of competitive goods, influence the quantity of the good at stake.

4.204 In the view of Chile, in "normal" goods, that is, goods that are consumed less if the price rises and more if the price falls, the own-price elasticity must be greater or equal to the cross-price elasticity of any competitive or substitutable good. If two goods could be substituted one for the other without any cost for the consumer (that means, they are almost equal products), the cross elasticity will be the same as the price elasticity (with sign changed) that is, a 1% increase in the price of a good, has the same effect on the consumption as a 1% decrease in the price of its competitor. If there is a cost in substituting those goods, then the same percentage price variation in the competitive good price has less effect on the demand than that percentage price variation of the good at stake. Thus, normally the maximum cross elasticity is equal to the price elasticity.

4.205 With this concept in mind, Chile reviews the results of 1998 SM survey, shown at Table 23 above. The survey was conducted in such a way that the respondents faced an hypothetical "once and for all" price variation, and therefore changes in demand are not influenced by changes in personal income, tastes, habits, etc. The only variable that changes is the price of different spirits.

4.206 Chile goes on to state that if it takes the border condition, that is, that cross elasticities are equal (in absolute value) to price elasticity (something not seen in the real world, but that presents the best case to sustain the reliability of the survey), it may calculate (with the data included in Table 23) what is the underlying minimum price elasticity.

4.207 Chile presents the following results:

Whisky:	-5
Other Spirits:	+2 (that is to say, an increase in price will mean an increase in consumption)
Pisco:	-0.5

4.208 In the opinion of Chile, the findings for whisky and other spirits are absurd, and speak loudly about the lack of reliability of the survey.

¹³² Chile Oral Statement at the Second Substantive Meeting, Table V.

4.209 Chile explains that in the case of the whisky, a price elasticity of -5, means that a 10% reduction in price (with the prices of every other spirit unchanged) will lead to an increase in terms of volume of 50%. This is absolutely out of range. The whisky industry will be very pleased to face such a price elasticity, but this is not the case. Consumer goods usually show price elasticity below 2. This "finding" is also rebutted by the experience in 1982 – 1986. By then, the price of whisky grew by 67%, and per capita consumption fell by 64%, therefore price elasticity is at the most 1 (if there is some cross elasticity with pisco, price elasticity will be even less than 1).

4.210 Chile concludes that no comments need to be made on the elasticities of other spirits, because it is clear that nobody could sustain that case. This exercise shows that the 1998 SM survey is far from being a robust consumer survey.

4.211 Chile also disagrees with the EC comment that the "decrease in pisco price may have had some influence in pisco consumption". It is easy to realize that, if a good has no response to its price (the quantity is the same no matter what its price is), its demand is said to be inelastic, and those goods has no competitors. Chile has developed at length the reason why such goods have no competitors. Therefore, the comment made by the European Communities in its rebuttal should be regarded as a plain economic error.

4.212 Chile claims that, in summary, the European Communities has failed to provide persuasive and sufficient evidence of its assertion that pisco and other spirits are directly competitive or substitutable, as requested by Article III:2, second sentence.

4.213 **The European Communities contests** Chile's argument that the 1998 SM survey is not reliable because it did not offer as a possible survey response the option to go to another shop when asking the question "what would you drink, if pisco were not available?". The hypothetical question of the best alternative drink is part of the standard repertoire of survey design. As the survey offers both the possibility to switch to another drink or to drink nothing at all, it provides a good indicative assessment of the level of substitutability between pisco and other types of alcoholic beverages. If substitutability were nil, no choice of an alternative drink would have been made. The hypothetical question is certainly not beyond the intellectual capacity of a consumer. The proposal that the respondent should have had the choice to go to another store is not a serious suggestion.

4.214 The European Communities also argues that it was stated that the elasticities implied by the survey lead to the impossible result that the elasticity of whisky consumption with respect to pisco prices (cross-price elasticity) is higher than the own-price elasticity. These results are certainly not in violation of any economic principle. Evidently, the survey choices made are plausible and intuitive. Furthermore, the statement may confuse cross-price elasticity with elasticity of substitution. Without going into the technical details, it has to be kept in mind that the market shares of whisky and pisco are very unequal. By way of example, the European Communities refers to the own-price elasticity the Chilean delegation appears to have derived from the survey, namely of 0.5 for pisco and 5 for whisky. If whisky consumption is 8,000 cases annually and that of pisco 100,000 (the ratio roughly represents the actual proportions), a 1 % price increase for pisco will lead to a reduced consumption of 500 cases, a 1% increase in whisky prices will affect 400 cases of alcoholic drinks. It can easily be seen that a price change in pisco can have more influence on whisky consumption than a price change in whisky itself.

4.215 The European Communities asserts that this result would even be stronger if one applies own-price elasticities that are less unequal than those derived by the Chilean delegation. The European Communities has used the Chilean values only as an example, because the European Communities has no means of assessing how the Chilean delegation might have calculated them.

4.216 In conclusion, the European Communities alleges that therefore, Chile's argument does not invalidate the technical correctness of the survey. Instead it can be summarised as stating simply that the Chilean delegation believes that the substitutability is lower than those derived from the survey.

(iii) *The 1995 Gemines study*

4.217 **The European Communities explains** that it has had access to a study entitled "The possible effects for the pisco industry of a reduction in the tax applied to whisky" carried out in August 1995 by Gemines, a respected firm of consultants, at the request of Chile's pisco industry (hereafter referred to as "the 1995 Gemines study").¹³³ This study provides further evidence of significant cross-price elasticity between pisco and whisky.

4.218 Further, the European Communities explains that the objective of the study was to quantify the effects for the pisco industry, and more generally for the economy of the *zona pisquera*, in the hypothesis that the ILA was amended so as to equalise the tax rates applied to pisco and whisky. Gemines considered two different scenarios. According to the first scenario, pisco and whisky would be taxed at 35 %. According to the second scenario, they would be taxed at 30 %.

4.219 According to the European Communities, as a first step, Gemines estimated the cross-price elasticity rate between pisco and whisky on the basis of historical sales and price data covering the period 1985-1992. The estimated rate was 0.26. This would indicate that if, for example, the prices of whisky went up by 10 %, the sales volume of pisco would increase by 2.6 %.¹³⁴ According to Gemines, that rate of cross-price elasticity is sufficient to conclude that pisco and whisky are "substitutes, albeit to a moderate extent".¹³⁵ By contrast, on the basis of similar regressions, Gemines reached the conclusion that neither wine nor beer could be considered as substitutable with pisco.¹³⁶

4.220 The European Communities states that Gemines then proceeded to estimate the changes in consumption of pisco and whisky that would take place in each of the two scenarios above described. As shown in Tables 25 and 26 below¹³⁷, Gemines concluded that sales of pisco would drop by 10.2 % in the first scenario and by 8.6 % in the second scenario, whereas sales of whisky would increase by 5.8 % and 6.5 %, respectively.

¹³³ EC Exhibit 20.

¹³⁴ The European Communities notes that cross-price elasticity measures the relative change in sales of one product as a result of a relative price change in another. However, cross-price elasticity itself is not neutral to the existing market shares of the product involved, and is dominated by the product with the larger share.

¹³⁵ The European Communities notes that the authors of the study cautioned that the estimated rate was likely to be lower than the current rate of cross-price elasticity. *See* 1995 Gemines Study, p. 57 (EC Exhibit 20).

¹³⁶ 1995 Gemines study, p. 61 and fn. 18 (EC Exhibit 20).

¹³⁷ 1995 Gemines study, p. 64 (EC Exhibit 20).

Table 25¹³⁸

First scenario

Pisco and Whisky taxed at 35 %

	Pisco	Whisky
<u>Price</u>	+ 7 %	- 18.6 %
<u>Quantity sold</u>	- 10.2 %	+ 5.8 %

Table 26¹³⁹

Second Scenario

Pisco and whisky taxed at 30 %

	Pisco	Whisky
<u>Price</u>	+ 3.5 %	- 21.3 %
<u>Quantity sold</u>	- 8.6 %	+ 6.5 %

4.221 The European Communities comments that these figures may underestimate considerably the increase in whisky consumption. In the first place, Gemines did not take into account the additional demand generated by whisky's cross-price elasticity to increases in the price of pisco, but only and exclusively the elasticity of whisky to changes in its own price. Moreover, unlike in the case of pisco, Gemines did not estimate whisky's actual rate of own-price elasticity. Instead Gemines limited itself to "assume" a rate of 0.31 on the basis of "the characteristics that exhibits this market and alternative studies".¹⁴⁰ That "assumed" rate, however, seems too low. In fact, that rate would be inconsistent with the cross-price elasticity rate of pisco in response to changes in the prices of whisky previously estimated by Gemines itself. On the basis of the latter rate (which itself appears to be an underestimate), an increase of 10 % in the price of whisky would generate an increase in sales of pisco which is much larger (2.6 % of approximately 75 % of the spirits market) than the total drop in sales of whisky caused by the same price increase on the basis of Gemines' assumed rate of own-price elasticity for whisky (3.1 % of approximately 4 % of the spirits market).

4.222 The European Communities further notes that the authors of the study cautioned that in practice the decline in the sales of pisco was likely to be even greater than shown in the above tables due to the fact that in both scenarios the changes in the price of whisky were much bigger than those considered in order to estimate the cross-price elasticity rate between pisco and whisky.

4.223 **In rebuttal, Chile argues** that with regard to cross-elasticity of demand, the European Communities has been unable to demonstrate high cross-elasticity of demand. The study cited by the

¹³⁸ EC First Submission, Table 19 (p. 62)

¹³⁹ Ibid., Table 20.

¹⁴⁰ 1995 Gemines study, p. 63 (EC Exhibit 20).

European Communities shows only a "moderate" substitutability between pisco and whisky, based on the 1995 Gemines study. A more thorough study over a longer period, conducted for the Chilean industry, as shown in Table 27 below, demonstrates an even lower degree of cross-elasticity. Such low cross-elasticity hardly demonstrates that the products are, in terms of Article III:2 "*directly competitive or substitutable* [emphasis supplied]".

Table 27¹⁴¹

Cross-price elasticity of pisco with other spirits, wine and beer

RESULTS OF THE REGRESSION

<i>Statistics of the regression</i>	
Multiple coefficient	0,9878
Coefficient of R ²	0,9758
Adjusted R ²	0,9624
Typical error	0,0640
Observations	15

ANÁLISIS OF THE VARIABLE

		<i>Sum of the squares</i>	<i>Average of the squares</i>	<i>F</i>	<i>Critical Value of F</i>
Regression	5	1,4895	0,2979	72,6767	5,32677E-07
Residual	9	0,0369	0,0041		
Total	14	1,5264			

ANALYSIS OF COEFFICIENTS

	<i>Coefficients</i>	<i>Typical error</i>	<i>Statistic t</i>	<i>Probability</i>	<i>Inferior 95%</i>	<i>Superior 95%</i>
Interception	3,5771	3,6554	0,9786	0,3534	-4,6920	11,8461
Variable X 1 (Income)	-0,0072	1,2109	-0,0059	0,9954	-2,7465	2,7321
Variable X 2 (Pisco Price)	-1,3109	0,4574	-2,8661	0,0186	-2,3456	-0,2762
Variable X 3 (Whisky)	0,1248	0,5158	0,2419	0,8143	-1,0421	1,2917
Variable X 4 (Wine Price)	0,5963	0,4030	1,4796	0,1731	-0,3154	1,5079
Variable X 5 (Beer Price)	0,3622	1,2132	0,2985	0,7721	-2,3823	3,1067

4.224 Chile explains that to estimate the cross-elasticity between pisco and other alcoholic beverages, an econometric methodology analysis was developed on the basis of a time-series of data. It is worth mentioning that econometric models are widely accepted as a useful tool to determine whether two products are strong substitutes or not.

4.225 Chile goes on to explain that the econometric model reached a highly satisfactory adjustment at global level, and the coefficient values (elasticities) have the sign expected by the economic theory: an increase in per-capita income will lead towards an increase in per-capita pisco consumption; an increase in pisco price will lead towards a diminishing in pisco consumption. However the only variable that, from a statistical standpoint has a significant coefficient (with a confidence level of 95%), was the pisco price, with a value of -1.31. That means that a 10% increase in the price of pisco, will result in a decrease of 13.1% in pisco consumption. According to the results of this mathematical model, the cross elasticity between pisco and whisky is not only very low (0.125), but statistically not significant (with 95% of confidence). An elasticity of 0.125, means that a 10% increase in the price

¹⁴¹ Chile First Submission, Annex II.

of whisky (for whatever reason), will increase pisco consumption by 1.25%. But this elasticity, being so low that these products cannot be considered close substitutes to each other, is also not significant from a statistical standpoint, that means the elasticity could be 0.

4.226 According to Chile, in order to deepen this analysis, a second regression was made, but in this case the per capita income variable was eliminated from the equation. It shows an improvement, and the coefficients maintain the signs that the theory indicates. In this case, pisco and wine prices appear as significant variables (with 95% of confidence), with the cross-price elasticity of wine being 0.59. In this case, whisky also presents a low elasticity (0.128), which is not statistically significant (with 95% of confidence).

4.227 Further, Chile states, that in order to investigate further, the price of beer was eliminated from the second regression analysis, since its elasticity coefficient is not significant (with 95% of confidence), even though it is higher than that for whisky. In this case, the equation of the regression only considers prices for pisco, wine and whisky. With this modification, the quality of the regression improves, and the coefficients maintain the sign theoretically indicated. In this regression, the price of pisco (elasticity = -1.50) and wine (cross elasticity = 0.78) remain as significant variables (with 95% of confidence), while the price of whisky (cross elasticity = 0.07) remains as not significant.

4.228 Chile then argues that based on the previous commentaries, it can be concluded that, using the econometric analysis (widely accepted at technical level), it is not feasible to demonstrate the existence of a significant cross elasticity of demand between pisco and whisky.

4.229 Chile further explains that the methodology used in the above regression (demand model with constant elasticity, estimated under the ordinary least squares) is identical to the one employed by Gemines in the 1995 Gemines study. In this case, the results differ from those indicated in the Gemines study because the price series used in one case and in the other are different: in the case of the Gemines study, a *quarterly series of prices* was used, which covers the period 1985 - 1992 (seven years). In the present case, an *annual series* of fifteen years was used (from 1983 to 1997). It is necessary to indicate that upon using quarterly series, even though the number of observations increases, a lot of distortions are introduced because of seasonal consumption factors. Some of these seasonal factors could be eliminated upon introducing variables such as a "dummy" (which is the Gemines methodology). However, models constructed with "dummy" variables are generally of a lesser quality than those models that do not require this class of variables, and this does not seem to be the exception.

4.230 **The European Communities alleges** that the only piece of evidence put forward by Chile is the regression analysis. The European Communities made several comments on it. First, the regression has serious methodological problems. Second, in spite of those problems, the regression confirms that pisco and whisky compete with each other: pisco consumption goes up when the price of whisky increases and falls when the price of whisky goes down. Finally, contrary to the claims made by Chile, the regression does not show a lower rate of cross-price elasticity than the 1995 Gemines study. Unlike the authors of the 1995 Gemines study, the authors of the Chilean regression analysis have used a simple linear regression. This means that the parameters estimated by them do not represent elasticities and, therefore, cannot be compared to the parameters estimated in the 1995 Gemines study.

4.231 The European Communities further contests that Chile has failed to rebut the extensive evidence provided by the European Communities showing that pisco and the other distilled spirits are "directly competitive or substitutable" in the Chilean market. The only piece of evidence adduced by Chile is the above regression analysis. That analysis concludes that the Chilean regression analysis is afflicted by fundamental multi-collinearity problems which render the results extremely unstable and

deceptive. Further, the paucity of the data set used by Chile is such that it is not possible to address those problems.

4.232 The European Communities explains that a difficulty inherent to all time-series data is that many variables are "collinear". This is the term used by econometricians in order to describe the fact that many values move in parallel over time without necessarily implying any causal relationship. An often cited textbook example is that of cumulative rainfall and the consumer price index, which both rise over time. A regression of one on the other would yield a high statistical correlation.

4.233 In addition, the European Communities recalls that cross-elasticity is not a one way relationship. Pisco prices also affect whisky sales. In light of the respective market shares of the two products, this reverse cross-price elasticity should even be larger than that the effect whisky prices have on pisco sales. In the view of the European Communities, Chile makes no effort to address this aspect.

4.234 **Chile also points out** that in the first place, it is for the European Communities to prove that the regression analysis that it has submitted to the Panel meets all the standards required to be considered a sound econometric exercise.

4.235 Chile further notes that as the European Communities pointed out, there are a number of tests to be carried out in the data employed in a regression, before one could use the results confidently. Chile acknowledges the effort put forward by the European Communities to review the Chilean regression analysis that was made with the annual data covering the 1983 – 1997 period, and agrees with the comments that the data contain some insolvable problems (namely multicollinearity).

4.236 Chile argues that the EC's criticism are ironic, however, because the regression submitted by the European Communities has even more serious problems; it covers a smaller number of years (all of them included in the regression submitted by Chile) and is further distorted by the use of quarterly data. Finally, and even more important, the elasticity coefficient is not significant (at 95% confidence level).

4.237 Chile again emphasized that in short, neither regression analysis is sufficiently reliable, but the EC's is less reliable than that of Chile, and it is the European Communities, not Chile, that has the burden of the proof.

(iv) *The 1996 Gemines study*

4.238 **The European Communities notes** that following the submission to Congress of the 1995 Proposal by the Chilean Government, the pisco industry commissioned from Gemines a new study in order to assess the impact of the proposed reduction of the taxes on whisky from 70 % to 50 % (hereafter, the "1996 Gemines study").

4.239 The European Communities states that it has not been able to obtain a copy of the 1996 Gemines study. Nevertheless, its findings were widely publicised by APICH (the association of pisco producers) in July 1996, following the announcement by the Government that it intended to submit an amendment to the 1995 Proposal providing for an even larger reduction of the tax on whisky. Details of the 1996 Gemines study were also cited by some members of the Chamber of Deputies during the debate of the 1997 proposal.¹⁴²

¹⁴² As an example, the European Communities refers to the intervention by Representative Prokurika, Minutes, p. 44 (p. 47 of the English translation).

4.240 The European Communities notes that according to press reports¹⁴³, the 1996 Gemines study concluded that the reduction of the tax on whisky to 50 % envisaged by the 1995 Proposal would cause a 47 % drop in the price whisky and, as a consequence, a 17 % reduction in the sales of pisco. The European Communities claims that the accuracy of those reports has not been disputed by Chile.

4.241 The European Communities notes that the first document it requested was the "1996 Gemines study". The relevance for this dispute of that study is thus unquestionable. Yet, Chile's pisco industry has refused to provide the 1996 Gemines study to the Panel.

4.242 The European Communities states that according to a letter from APICH (the association of pisco producers) which has been forwarded by the Chilean Government to the European Communities, the reasons for that refusal are twofold. The first reason is that the study contains information "confidential" to Capel and Control. The second reason is that Capel and Control were not "satisfied with the results of the study, which did not achieve the expected results". For those two reasons, the letter concludes, "the study was never made public".

4.243 The European Communities then claims that to begin with, one may doubt of the "confidentiality" of business information which has been shared by the two main pisco producers without any apparent restriction. If it is true that the study contains confidential business information, then Chile's anti-trust authorities would be well advised to ask for a copy.

4.244 The European Communities further points out that, in any event, back in 1996 the pisco industry did not treat the study as "confidential". In July of that year APICH convened a press conference at which, brandishing the 1996 Gemines study as irrefutable evidence, APICH warned that if the Government proposal was adopted, sales of pisco would fall by 17 %. This was the same press conference at which the Chairman of APICH recalled that when at the beginning of the 1980s the tax differential between pisco and whisky was reduced to 5 %, "pisco producers were almost chased out of the market".

4.245 Also, the European Communities states that the press conference of July 1996 was part of a strategy aimed at stopping the Government from submitting an amendment to the proposal then pending before the Parliament that would have provided for a larger reduction of the tax on whisky. With the same purpose, the 1996 Gemines study was also provided by APICH to some members of the Chilean Congress, who quoted it extensively during the subsequent debate of the Government proposal.

4.246 The European Communities alleges that the inescapable conclusion is that in 1996 the pisco industry was telling to the Chilean Government and to the Chilean Parliament a totally different story from that presented to the Panel.

4.247 The European Communities argues that, in any event, neither APICH nor the Chilean authorities have explained why it is not possible to provide a non-confidential summary of the 1996 Gemines study. In view of that, the European Communities would urge the Panel to draw appropriate inferences from the attitude of Chile's pisco industry.

4.248 **In rebuttal, Chile comments** that the eagerness of the European Communities to request private documents prepared for the pisco industry as the Adimark study and Gemines 1996 study, is absolutely abnormal in this type of process. On one hand, the European Communities, not Chile's industry, has the burden of proving its assertions; on the other, nothing has prevented the European Communities or its industry from conducting all the surveys in Chile that they may wish; the Chilean

¹⁴³ *El Diario*, 2 July 1996 (EC Exhibit 30).

industry -- like the Scotch Whisky Association -- is under no obligation to provide the information or advice it gets from private consultants.

(v) *The Adimark Survey*

4.249 **The European Communities notes** that the same press reports referred to another survey commissioned by APICH (the "Adimark survey") in order to assess the reactions of the different socio-demographic segments of the Chilean population to the proposed tax changes. The survey concluded, *inter alia*, that young consumers, in particular, considered that the reduction in the tax applied to whisky would provide a "good alternative to replace pisco".¹⁴⁴

4.250 According to the European Communities, the Adimark survey is a qualitative study based on the opinions expressed by consumers within four "focus groups", composed of 6 to 8 people (all males) each. The study covers two socio-economic segments: ABC1 (which is believed to correspond to the middle-high to high income segments) and C2 (which would correspond to the middle-middle income segment); and two group ages: from 19 to 24 years and from 25 to 36 years.

4.251 The European Communities explains that although the use of "focus groups" is a usual research method for marketing purposes, its results are less reliable than those obtained through quantitative research methods (such as those used in the 1997 and 1998 Search Marketing studies submitted by the European Communities). Nonetheless, the findings of the Adimark study provide further confirmation that whisky and pisco are directly competitive and substitutable in the Chilean market.

4.252 The European Communities states that according to the Adimark study, a decrease in the price of whisky would provoke the following reactions in the ABC1 segment¹⁴⁵:

- (i) "a strong incidence in the frequency of whisky consumption (it would be purchased more often)";
- (ii) "a feeling of displacement of pisco mainly (as opposed to other beverages)"; and
- (iii) "a tendency to substitute [whisky] for the consumption of pisco (including for consumption in 'carretes' by the young population)".

4.253 According to the European Communities, in the case of segment C2, reactions are more nuanced, but nevertheless strongly supportive of a finding of direct competition.¹⁴⁶ On the one hand, the consumers in this segment express the view that, if the price of whisky decreased, they would increase their consumption of whisky at the expense of pisco. On the other hand, they anticipate that in the longer term they would progressively revert to pisco. However, the main reason given for that prediction is that pisco is a "traditional" drink with a strong Chilean identity, whereas whisky is a "foreign" spirit. Thus, the apparent resistance of consumers in this segment to a permanent change is motivated by their subjective perceptions about the identity of the products, rather than by the existence of objective differences between them. Those subjective perceptions are likely to change as the consumption of whisky becomes more frequent and whisky loses its "foreign" label in this segment (a process which, according to the study, would have already been completed in the higher income ABC1 segment, where consumers have been exposed to foreign spirits longer and are less "nationalistic" in their choices).

¹⁴⁴ Ibid.

¹⁴⁵ Adimark study, submitted by Chile, p. 18. See also pp. 20-21.

¹⁴⁶ Ibid., pp. 18 and 21-23.

4.254 **Chile argues** that in regard with the Adimark survey, it is worth mentioning that it is a qualitative study, based on 4 "focus group" of 6 - 8 people each. Therefore the total sample is just about 30 people, which does not constitute, under any consideration, a sample that allows for drawing valid conclusions about market behaviour. This type of study, being a research method employed for marketing purposes, conveys only preliminary results on the issue investigated. In terms of the quality of the information provided, they are less reliable than normal and well conducted quantitative market research analysis.

4.255 Chile goes on to state that as it has shown, the illogical quantitative results of the Search Marketing study render it useless as an evidence before this Panel; *a fortiori*, the Adimark survey has even less usefulness as evidence.

4.256 Chile further argues that if, in spite of the above, the Panel would still consider the Adimark survey as evidence, the conclusions drawn from it validate Chile's position, that is, that pisco and whisky are competitive only to a very limited extend, based on the following:

- (i) According to the survey pisco and whisky are both consumed by the ABC1 segment, but in different occasions: Pisco when hanging out with friends and whisky in important social events (e.g., wedding parties, official receptions at the European embassies, and the like).
 - (ii) The survey shows that young people belonging to the ABC1 segment will change from pisco to whisky only in case the price of whisky is reduced substantially, as to reach the price of pisco, which seems extremely unlikely to occur, even if taxes are not levied at all.
 - (iii) The survey shows those in segment C2 (the most important segment in terms of consumption and certainly poorer than ABC1) would not substitute whisky for pisco due to considerations concerning the national attribute of pisco.
 - (iv) According to the survey, the only substitution that has been proved is that between whisky and high alcohol content pisco (which is taxed identically with whisky).
- (vi) *Position of Domestic Industry and the Government of Chile*

4.257 **The European Communities also argues** that the producers of pisco have recognised openly that pisco and other spirits are directly competitive and substitutable products. As mentioned above, in July 1996 APICH gave broad publicity to the findings of the 1996 Gemines study, which concluded that lowering the tax on whisky to 50 % would result in a 17 % drop in the sales of pisco. According to the same reports, Mr. Peñafiel (the general manager of Capel, speaking as the representative of APICH) recalled on that occasion that:

... at the beginning of the 80s the tax difference between pisco and whisky was 5 % and pisco producers were almost chased out of the market. Nowadays, this is a latent risk. The situation may have changed a lot, but whisky is a pole of attraction for an important segment of the population.¹⁴⁷

¹⁴⁷ *El Diario*, 2 July 1996, (EC Exhibit 30). The European Communities adds that the successive increases of the tax rate on whisky from 30 % to 70 % between 1983 and 1985 were prompted by complaints of the pisco industry against growing imports of whisky.

4.258 The European Communities further points out that equally open as to the existence of a competitive relationship between whisky and pisco was Mr. Elorza, general manager of Control, who reportedly stated that:

Any change in the taxes may strongly affect us. Pisco is an agricultural product and for that reason the law is protectionist. In contrast, whisky is an industrial product.¹⁴⁸

4.259 The European Communities concludes that beyond these statements by two of the industry's top managers, it is evident that the concern shown by the pisco producers throughout the amendment process of the ILA would have been totally unwarranted, had that industry not been convinced that pisco and the other spirits are directly competitive and substitutable products.

4.260 The European Communities alleges that in particular, the pisco industry's request that the tax rate be increased by 6 percentage points per degree of alcohol instead of by 5 percentage points (as provided for in the 1995 Proposal) evidences that its main concern was to limit the reduction of the taxes on whisky, rather than the increase of the taxes on high strength pisco. That concern would have been irrational unless the pisco industry had recognised the existence of direct competition between pisco and whisky.

4.261 The European Communities also claims that likewise, the strong resistance of the pisco industry to the further reduction of the tax rate on whisky to 40-45 % (instead of 50 %, as provided for in the 1995 Proposal) that was envisaged by the Government in July 1996 would have been senseless if whisky and pisco were not directly competitive products, the more so since that reduction would have benefited not only whisky but also *pisco reservado* and *gran pisco*.

4.262 The European Communities further asserts that similarly, the pisco industry's insistence on a long transitional period not just for phasing in the increase of the taxes on pisco but also the reduction of the taxes on whisky would be difficult to understand unless it was based on the assumption that those two spirits are directly competitive and substitutable.

4.263 The European Communities goes on to state that the pisco industry was not alone in considering that pisco and other spirits were directly competitive and substitutable. During the debate of the 1997 Proposal by the Chamber of Deputies, the existence of direct competition between pisco and whisky was assumed without discussion by all the speakers, including those who championed the cause of the pisco industry. Indeed, the representatives of the *zona pisquera* tended to emphasise that relationship in order to demonstrate the extent of the "sacrifice" consented by the pisco industry and, therefore, the need for public financial support to that industry.

4.264 The European Communities further alleges that the open recognition by the Chilean Government, as well as by many legislators, that the tax system in force until November 1997 needed to be amended because it was "discriminatory" against whisky and favoured the pisco producers necessarily presupposes the admission that pisco and other spirits are directly competitive and substitutable.

4.265 The European Communities notes a recent factual development of some importance for this dispute. According to press reports¹⁴⁹, Chile's anti-trust watchdog just authorised the merger of Control or Capel, the two largest producers of pisco, with a combined market share of 99 %. The main reason invoked by Chile's anti-trust authorities for clearing the merger was that the new company will be subject to competition from other "substitutable" liquors, including imported

¹⁴⁸ *Qué Pasa*, 2 March 1996 (EC Exhibit 26).

¹⁴⁹ EC Exhibit 65.

distilled spirits. According to the same press reports, another consideration taken into account was that the new company would be better positioned "to face external competition".

C. "NOT SIMILARLY TAXED"

1. Overview

4.266 **The European Communities argues** that under the Transitional System pisco and other "directly competitive or substitutable" distilled spirits are "not similarly taxed," and under the New Chilean System, the majority of pisco and the other distilled spirits are "not similarly taxed". In both cases, the tax differentials are well above *de minimis*.

4.267 The European Communities also claims that while the two panel reports on *Japan – Taxes on Alcoholic Beverages I* and *II* stand for the proposition that the application of specific taxes in direct proportion to the alcohol contained in each type of distilled spirits does not constitute "dissimilar" taxation of the spirits, this reasoning does not apply to the New Chilean System.

4.268 **In rebuttal, Chile states** that in the New Chilean System, all spirits, regardless of type and regardless of whether imported or domestic, are taxed according to the identical objective criteria of alcohol content and value, two objective criteria that have been widely accepted as taxation basis. According to Chile, objective criteria can result in taxation that, by some alternative measures, is not identical; for example, a specific tax system results in a higher tax on low priced goods, measured in *ad valorem* terms as well as distorting price relationships. However, in the view of Chile, GATT Article III does not prohibit a tax or regulation simply because, as a result of the application of objective criteria, some or even many imported products are by some measures treated worse than some or many like or competing domestic products. This position is supported by past panel reports and the Appellate Body in *Japan - Taxes on Alcoholic Beverages II*.

2. EC Main Argument

4.269 **The European Communities states** that, as confirmed by the Appellate Body in *Japan – Taxes on Alcoholic Beverages II*, two competitive or substitutable products must be considered as not being "similarly taxed" whenever the difference in taxation between them is more than *de minimis*.¹⁵⁰ According to the same report, whether any particular tax differential is or not *de minimis* must be determined on a case-by-case basis.¹⁵¹

(a) Transitional System

4.270 **The European Communities points out** that as shown in Table 1 above, the rate on whisky will be higher than the rate on pisco throughout the duration of the transitional period. Moreover, despite the progressive reduction of the rate on whisky, the tax differential will remain very large. As from 1 December 1999, when the tax differential will reach its lowest level, the rate on whisky (53 %) will still be more than twice the rate on pisco (25 %). A tax differential of such magnitude is more than *de minimis*.

4.271 The European Communities also notes that as shown in the same table, pisco will also be taxed at a lower rate than the category of "other spirits" during the transitional period. The European Communities argued that although the tax differential is smaller than the differential between pisco and whisky, it is still large enough to be capable of affecting the competitive relationship between the products concerned, as attested by the findings of the 1998 SM survey discussed above.

¹⁵⁰ Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II*, *supra.*, p. 23.

¹⁵¹ *Ibid.*

(b) New Chilean System

4.272 **The European Communities claims** that the Appellate Body considered a similar situation in *Canada - Periodicals*. One of the measures in dispute in that case was an internal excise tax applied by Canada to "split-run" periodicals (both imported and domestic), which was not imposed on "non-split-run" periodicals (whether imported or domestic). Canada claimed that there was no violation of Article III:2 because imported periodicals "as a class" were not taxed in excess of domestic products "as a class". The Appellate Body rejected this argument. According to the Appellate Body, although all "split-run" periodicals were equally taxed irrespective of their origin, the fact that imported "split-run" periodicals were not similarly taxed to domestic "non-split run" periodicals was sufficient to establish that there was "dissimilar taxation" for the purposes of Article III:2, second sentence:

Following the reasoning of the Appellate Body in *Japan – Taxes on Alcoholic Beverages*, dissimilar taxation of even some imported products as compared to directly competitive or substitutable products is inconsistent with the provisions of the second sentence of Article III:2.¹⁵²

4.273 The European Communities further explains that in reaching that conclusion, the Appellate Body invoked the well-known principle established by the Panel Report on *United States – Section 337 of the Tariff Act of 1930*, according to which:

... the "no less favourable treatment" requirement of Article III:4 has to be understood as applicable to each individual case of imported products ...¹⁵³

4.274 The European Communities then states that as evidenced by Table 3 above, under the New Chilean System the majority of pisco will continue to be taxed at a lower rate than the main types of imported spirits. Whereas *pisco tradicional* and *pisco especial* (which together account for 90 % of the sales of pisco) will be taxed at 27 %, whisky, vodka, rum, gin and tequila will be taxed at 47 % and brandy at a rate ranging from 39 % to 47 %. Those tax differentials are well above the *de minimis* threshold.

4.275 In the view of the European Communities, the fact that under the New Chilean System some pisco is taxed at the same rate as the main types of imported spirits does not mean that pisco and those spirits are "similarly taxed" for the purposes of the second sentence of Article III:2. The imported spirits in question do not compete with *pisco reservado* or *gran pisco* only. They are "directly competitive or substitutable" with all types of pisco and, therefore, should be taxed "similarly" to all pisco.

4.276 The European Communities also argues that the two panel reports on *Japan – Taxes on Alcoholic Beverages I* and *II*¹⁵⁴ suggest that the application of specific taxes on alcoholic beverages according to alcohol content does not constitute "dissimilar taxation" for the purposes of Article III:2, provided that the tax rate per degree of alcohol is the same, irrespective of the beverage in which the alcohol is contained. The underlying rationale is that those taxes are not so much taxes on the alcoholic beverages themselves as taxes on their principal common ingredient: the alcohol content.

¹⁵² Appellate Body Report on *Canada - Periodicals*, *supra.*, p.29.

¹⁵³ Panel Report on *United States – Section 337 of the Tariff Act of 1930* (hereafter "*United States - Section 337*"), BISD 36S/345, para. 5.14.

¹⁵⁴ The European Communities notes that the taxes applied by Japan in that case were expressed in terms of a certain amount of Yen per litre of beverage. That amount varied according to (but not proportionally) to the alcohol content.

4.277 The European Communities refers to the Panel Report on *Japan – Taxes on Alcoholic Beverages I*, which stated that:

[The] unqualified wording [of Article III:2, first sentence] does not necessarily mean that there could never be circumstances in which different tax treatment of "like products" was compatible with the General Agreement. The panel noted, for instance, that GATT Article III:2, a) [*sic*] permitted the non-discriminatory taxation "of an article from which the imported product has been manufactured or produced in whole or in part" and that such a non-discriminatory alcohol tax on like alcoholic beverages with different alcohol contents could result in differential tax rates on like products.¹⁵⁵

4.278 The European Communities then claims that the present dispute, however, is concerned with a totally different system of taxation. To begin with, the ILA is an *ad valorem* tax and not a specific tax. Furthermore, although the applicable rates vary according to alcohol content, the ILA is assessed on the value of the beverage, which is not directly related to the value of the alcohol content. For those reasons, unlike the specific taxes considered by the two panel reports on *Japan – Taxes on Alcoholic Beverages I* and *II*, the ILA cannot be characterised as a tax on the alcohol content.

3. Chile - "Objective Criteria" Argument

4.279 **Chile replies** that there is no precedent for holding inconsistent with GATT 1994 a system of taxation that does not discriminate based on nationality and that employs strictly objective criteria for any differentiation in taxes. Indeed, the same panels that condemned the Japanese System – and even the European Communities itself in arguing those cases – observed that distinctions based on objective and neutral criteria are permissible under Article III:2.

4.280 Chile also states that Article III does not prohibit a tax or regulation simply because, as a result of the application of objective criteria, some or even many imported products are by some measures treated worse than some or many like or competing domestic products. The drafting history of Article III makes this clear. In the latter stages of the drafting of what became Article III of the GATT, the negotiating Sub-Committee responsible for this Article reported:

The Sub-Committee was in agreement that under the provisions of Article 18 [Article III of the GATT], regulations and taxes would be permitted which, while perhaps having the effect of assisting the production of a particular domestic product (say, butter) are directed as much against the domestic production of another product (say, domestic oleomargarine) of which there was a substantial domestic production as they are against imports (say, imported oleomargarine).¹⁵⁶

4.281 In the view of Chile, the logic of this unanimous understanding of the negotiators is compelling. All WTO Members make tax and regulatory distinctions that fall unevenly by some measures among products that might be considered like or directly competitive or substitutable in the sense of Article III. Sometimes these distinctions will mean that many domestic products will, by some measures, be taxed or regulated more favorably than many like or competing imports. But that is not a violation of Article III, where criteria for the distinctions are objective and neutral.

4.282 Chile also argues that past panels have repeatedly acknowledged these considerations, noting also that Article III is not intended to be used as a tool for harmonizing the tax systems of the WTO Members,¹⁵⁷ and WTO Members retain almost complete freedom with respect to domestic policies

¹⁵⁵ Panel Report on *Japan - Taxes on Alcoholic Beverages I*, *supra.*, para. 5.9 d).

¹⁵⁶ Reports of the Committees and Principal Sub-Committees, ICITO 1/8, 64 (Geneva, Sept. 1948).

¹⁵⁷ See Panel Report *Japan - Taxes on Alcoholic Beverages I*, *supra.*

that do not distinguish between the origin or destination of goods.¹⁵⁸ In *United States - Measures Affecting Alcoholic and Malt Beverages*, the panel noted that:

The purpose of Article III is not to harmonize the internal taxes and regulations of contracting parties, which differ from country to country.¹⁵⁹

4.283 Chile further argues that in *Japan – Taxes on Alcoholic Beverages I*, the panel affirmed this principle with respect to Article III:2, noting that this Article "prohibits only discriminatory or protective taxation of imported products but not the use of differentiated taxation methods as such ..."¹⁶⁰ The panel went on to say "that Article III:2 does not prescribe the use of any specific method or system of taxation ..."¹⁶¹ This position was also endorsed by the Appellate Body in *Japan - Taxes on Alcoholic Beverages II*.¹⁶²

4.284 Chile then claims that the EC argument against the Chilean system ignores these precepts of Article III, and instead asks the Panel to strike down an objective and neutral tax system merely because a result of the application of that system is that those EC beverages of high alcohol content (and high price) will face higher taxes than those Chilean beverages (primarily certain kinds of pisco) that are of relatively low alcohol strength (and price). In making this argument with respect to the New Chilean System, the European Communities ignores that many European products, including those most similar to pisco, will benefit from the same lower rates of tax, while other European products could be adapted for the Chilean market merely by diluting with water the current relatively high strength of the products -- as the European Communities has suggested could be done by pisco producers. Equally, the European Communities ignores that under the New Chilean System many Chilean distilled spirits, including Chilean whisky, brandy and gin and very substantial quantities of pisco that are marketed at relatively high prices and alcohol strength, will face the highest rate of taxation.

4.285 Chile then concludes that the New Chilean System thus presents precisely the kind of regulatory system that Article III is not intended to condemn:

- (i) there is no distinction in taxation based on origin or on type;
- (ii) many imports can benefit from the lowest tax and all others could be easily diluted for that purpose;
- (iii) many domestic products of Chile will face the highest tax rates under the New Chilean System; and
- (iv) the objective standards mean that foreign producers can readily adapt their products to lower their taxes by a simple process.

4.286 In its support, Chile adds that the Appellate Body has properly noted that "Article III protects expectations not of any particular trade volume but rather of the equal competitive relationship between imported and domestic products".¹⁶³ Foreign and domestic producers have an equality of competitive opportunities, as they have an equal opportunity to adapt their production, if they so

¹⁵⁸ Panel Report on *United States - Measures Affecting Alcoholic and Malt Beverages* (hereafter, "*United States - Malt Beverages*"), BISD 39S/206, para. 5.25 and Panel Report on *United States - Taxes on Automobiles*, 33 I.L.M. 1397 (1994), para. 3.108.

¹⁵⁹ Panel Report on *United States - Malt Beverages*, para. 5.71.

¹⁶⁰ Panel Report on *Japan - Taxes on Alcoholic Beverages I*, *supra.*, para. 5.9 b).

¹⁶¹ *Ibid.*, para. 5.9 c).

¹⁶² See Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II*, *supra.*, p. 26.

¹⁶³ *Ibid.*, p. 16 (citations omitted).

choose, in the way implicitly preferred under the New Chilean System, i.e., by reducing alcohol content.

4.287 Further, Chile notes that the European Communities itself in this matter recognizes that "the New Chilean System abolishes formally the distinction between pisco and the other types of distilled spirits". The criterion of alcohol content is neutral and objective, and one that past panels and the European Communities itself have cited as an example of a tax category corresponding to objective product differences.

4.288 Chile further argues that the panel in *Japan - Taxes on Alcoholic Beverages I* endorsed use of alcohol content as a permissible objective means of taxation. The panel suggested that the application of different tax rates would be consistent with Article III:2 if the different tax rates were based on objective criteria, and relative alcohol content was specifically cited and endorsed as an example of an approach that could be acceptable. In rejecting the Japanese tax structure subject to dispute in *Japan - Taxes on Alcoholic Beverages I*, the panel observed that it:

was unable to find that the differences as to applicability and non-taxable thresholds of the *ad valorem* taxes were based on corresponding objective product differences (e.g., alcohol contents) and formed part of a general system of internal taxation equally applied in a trade-neutral manner to all like or directly competitive liquors.¹⁶⁴

4.289 It should be observed, according to Chile, that the panel did not object to the existence of non-taxable thresholds, nor did the panel require that the system apply taxes in direct proportion to alcohol content. Rather, the panel found the Japanese system deficient in applying a different scale to different types of distilled spirits that had been found directly competitive or substitutable.

4.290 In its further support, Chile points out that in the *United States - Taxes on Automobiles* case, the European Communities argued that the Japanese tax system examined by the panel in *Japan - Taxes on Alcoholic Beverages I*, "did not correspond to a rational overall system for taxing all liquors, such as one based on *alcohol content*".¹⁶⁵

4.291 Chile also notes that the European Communities itself, in its challenge of the Japanese system of taxation of alcoholic beverages specifically commended both alcohol content and value as acceptable neutral ways of varying taxes on like and directly competitive practices. In this respect, the European Communities argued that the panel in its analysis of an alleged violation of Article III should:

determine whether the category as a whole is taxed in excess of the corresponding category of domestic products. This would not be the case if the proportional variations in taxation on the basis of, e.g., alcohol content, are equally and uniformly applied to this category of like products, both domestic and imported.¹⁶⁶

4.292 Chile further notes that similar views have been expressed before the European Court of Justice ("ECJ"). The ECJ in Case 170/78, *Commission v United Kingdom*, 1983 ECR 2265 noted that:

[T]he Commission has recommended that spirits should be charged at a higher rate of duty according to alcoholic strength than liqueur wines. It appears, therefore, to have

¹⁶⁴ Panel Report on *Japan - Taxes on Alcoholic Beverages I*, *supra.*, para. 5.9 b).

¹⁶⁵ Panel Report on *United States - Taxes on Automobiles*, *supra.*, para. 3.92 (emphasis added by Chile). Chile also referred to Panel Report on *Japan - Taxes on Alcoholic Beverages II*, *supra.*, para. 4.45.

¹⁶⁶ Panel Report on *Japan - Taxes on Alcoholic Beverages II*, *supra.*, para. 4.48.

accepted that there are social reasons for imposing a relatively higher rate of taxation on beverages with a higher alcoholic content.

4.293 In the view of Chile, on the contrary, the European Communities argues that under the New Chilean System many spirits imported from the European Communities are and will be of relatively high alcohol content, and therefore more heavily taxed, while many spirits produced in Chile are and will be of relatively lower alcohol content and hence less heavily taxed. While those points are true, they present an incomplete picture of the facts and an inadequate basis to find a violation of Article III:2. Much Chilean pisco is taxed at the lowest rate of 27%, but Chile also produces a large volume of products containing 40° alcohol content or more, including domestically produced whisky, gran pisco, pisco reserved, 40° brandy, rum, gin, and vodka, and these products will be taxed at a rate of 47%, the highest tax bracket. It is also significant that many distilled spirits produced in Europe and elsewhere contain 35° alcohol or less and will be taxed in Chile at a rate of 27%, including aguardiente, grappa, fruit liquors, cocktails, other liquors, and even shochu. Therefore, just as some domestically produced products benefit from the lowest tax bracket, it is equally true that a significant amount of domestically produced whisky and gran pisco faces the highest tax rate of 47%.

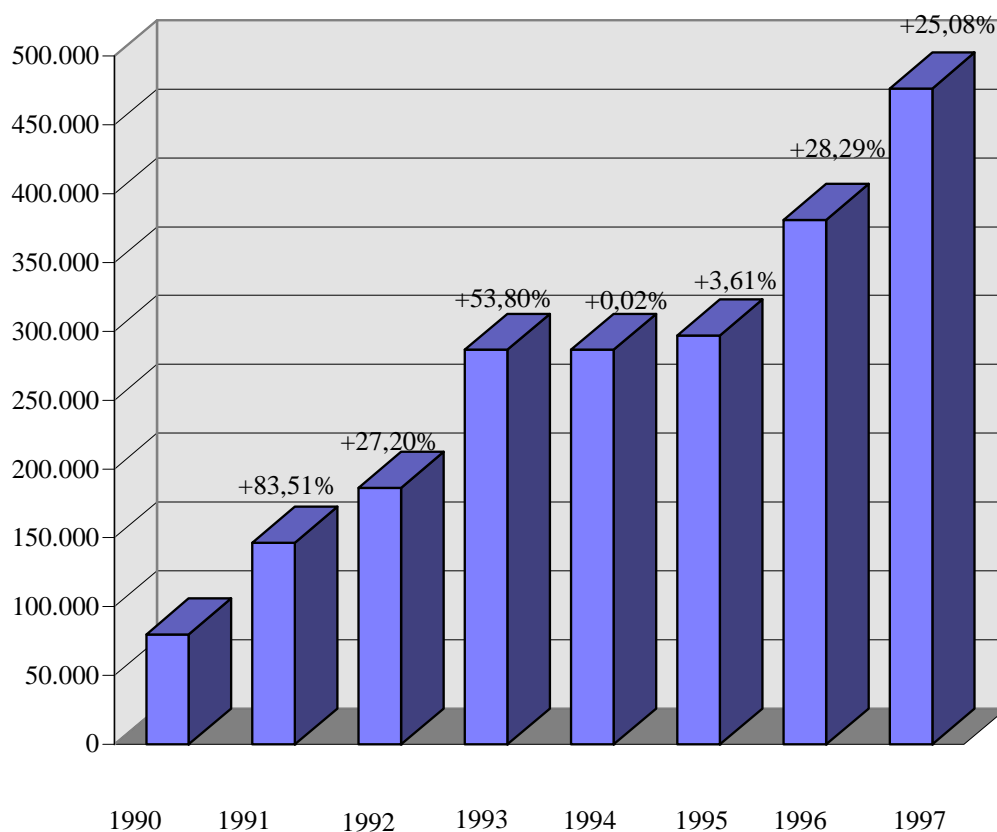
4.294 Chile further provides Chart 3 to show the growing volume of sales of premium grades of pisco with relatively high alcohol content that will face the highest rates of taxation under the New Chilean System.

Chart 3

Sales volume and growth rates of premium grades of Pisco

(Pisco from 40° to 46°)

Mercado Cajas 40° a 46°



4.295 Chile also presents tables showing the best available information concerning production and sales of various types of distilled spirits in Chile.¹⁶⁷

4.296 Chile then concludes that in any event, where objective standards are applied, GATT Article III does not require that internal taxes and measures must always *result* in proportional effect on imported and domestic products. To take an obvious example, *ad valorem* taxes are permissible under GATT, even though imported products that are higher priced or already face customs duties may thereby have to face higher tax per unit than domestic products. The European Communities

¹⁶⁷ Chile First Submission, Annex III.

itself has endorsed the idea that horsepower or engine displacement taxes are permissible. Chile agrees, even though such taxes almost certainly fall disproportionately heavily on automobiles of the type that Americans or Canadians are more likely to produce.

4.297 Chile further rebuts the EC argument that the New Chilean System cannot be characterized as a tax on alcohol content because it is based on an *ad valorem* tax rather than a specific tax. The European Communities states that the Chilean tax, although varying according to alcohol content, is "assessed on the value of the beverage, which is not directly related to the value of the alcohol content" and thus cannot be "characterized as a tax on the alcohol content". It is not clear what point the European Communities is trying to make here or how it furthers their argument, but in any event their analysis is fundamentally irrelevant and leads to an incorrect conclusion. The New Chilean System is based on both alcohol content and *ad valorem*; two criteria that have been recognized and accepted by previous panels under GATT as objective criteria.

4.298 Chile further argues that panels have even found that different systems could be used for imported and domestic products, if objectively based. It is not necessary for this Panel to go that far in this dispute, since the New Chilean System applies an identical system without regard to whether distilled spirits are imported or domestically produced. Nevertheless, it is instructive that the panel in *Japan - Taxes on Alcoholic Beverages I* noted that:

Article III:2 does not prescribe the use of any specific method or system of taxation ... there could be objective reasons proper to the tax in question which could justify or necessitate differences in the system of taxation for imported and for domestic products.¹⁶⁸

This position was also endorsed by the Appellate Body in *Japan - Taxes on Alcoholic Beverages II*.¹⁶⁹

4.299 Chile also argues that the overriding requirement of Article III:2 is not to discriminate in favor of domestic goods and against imported goods on the basis of national origin of a product. Almost all cases brought to GATT and WTO panels under Article III:2 have involved measures that, on their face, afforded more favorable treatment to some or all domestic goods than to imported goods.

4.300 Chile explains that a legislator should also be aware that a measure that formally does not discriminate based on nationality may nevertheless be found to contravene Article III:2, second sentence, if the effect of the measure is to make more favorable treatment available exclusively or virtually exclusively to domestic products to the disadvantage of imported products. GATT and WTO panels have gone furthest in extending the concept of *de facto* discrimination based on national origin of a product in the recent alcoholic beverage taxation cases against Japan and Korea. Both of those countries had tax systems in which one type of distilled spirit was taxed at a far lower rate than other distilled spirits. Further, in each case, domestic producers accounted for virtually all domestic consumption of shochu or soju, because various measures effectively prevented imports of shochu/soju from competing in the domestic market. In these circumstances, where there was no possibility for foreign producers to obtain the benefits of the low tax accorded to shochu/soju, and where the panel found that the favoured product was like or directly competitive or substitutable with other types of distilled spirits, these systems were held to contravene Article III:2.

4.301 In the view of Chile, on the other hand, laws and regulations based on objective criteria such as those used in the New Chilean System have rarely been challenged in the GATT and have never been successfully challenged, even when the tax system may result in less favorable treatment for some or many imported goods than for some or many domestic goods. For example, in the *United*

¹⁶⁸ Panel Report on *Japan - Taxes on Alcoholic Beverages I*, *supra.*, para. 5.9 c).

¹⁶⁹ See Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II*, *supra.*, p. 26.

States - Taxes on Automobiles case, the panel found that the United States had *not* breached Article III:2 by imposing a luxury tax on vehicles above a certain threshold value.¹⁷⁰ The U.S. tax resulted in far higher taxes on certain European products, which dominated the U.S. market for cars priced significantly above the threshold price and thus accounted for the vast majority of the revenue collected from the tax on European cars. However, far more imports, including a significant number of imports in the price categories most directly competitive with U.S. "luxury cars," paid a minimal tax or no tax at all.

4.302 Chile further argues that while the reasoning of the *United States - Taxes on Automobiles* panel (the so-called "aim and effects" test) was not followed subsequently by the Appellate Body, it believes that the result would have been the same under the three part test applied by the Appellate Body in *Japan – Taxes on Alcoholic Beverages II*.¹⁷¹ The luxury tax imposed by the United States was based on objective criteria (a tax on the value of cars in excess of a fixed luxury level) that applied to both domestic and imported cars, and imported cars could and did benefit from the tax exemption granted to all cars below the exemption.

4.303 Chile then points out that comparing that system to the Chilean system of taxation of alcoholic beverages, it might be noted that it is easier as a practical matter for foreign producers to adapt the alcohol strength of their product than for car producers to reduce their prices.

4.304 Chile also notes that similarly, even though specific taxes such as those imposed on alcoholic beverages in several EC Member States have a marked discriminatory effect on low priced imported products relative to high priced domestic products such as Scotch whisky or even imported high priced products such as U.S. or Canadian whisky, Chile has believed that a challenge of such tax systems under Article III (or Article I which requires most favoured nation treatment with respect to matters covered by Article III:2) would probably not be successful because the tax standard is objective, even if its effect disfavors low price products.

4.305 Chile also argues that it is likewise inconceivable that members of the WTO, particularly developing country members, thought or think that, in joining the WTO and accepting thereby the obligations of Article III:2, they were foregoing the right to use fiscal policy tools such as luxury taxes or exemptions or reduced taxes for goods purchased primarily by poor consumers, even if such policies result in higher taxes on many imports than on many like or directly competitive products.

4.306 **The European Communities replies** that Chile's defence in this case is built upon the argument that tax distinctions linked to differences in alcohol content do not constitute "dissimilar taxation" because they are "objective" and "neutral". While those two terms are constantly repeated by Chile, their precise meaning is nowhere explained. As shown below, the legal test embodied in Chile's argument would lead in practice to unacceptable consequences.

4.307 The European Communities argues that to begin with, one may wonder what qualifies as an "objective" tax distinction. Or, rather, one should ask what does not qualify as an "objective" tax distinction. Differences between spirits with respect to factors such as ingredients, colour or even taste are no less "objective" than differences in alcohol content. They are as readily observable and can be measured with the same precision. In view of that, why should tax distinctions based on one or more of those characteristics be treated differently than the tax distinctions based on alcohol content?

4.308 The European Communities further states that on the other hand, if one accepts the view that "objective" tax distinctions between products may never constitute "dissimilar" taxation, the second sentence of Article III:2 becomes redundant. Indeed, the existence of two "directly competitive or

¹⁷⁰ See Panel Report on *United States - Taxes on Automobiles*, *supra*.

¹⁷¹ See Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II*, *supra*.

substitutable" products presupposes, by definition, that there is some sort of "objective" difference between them. Otherwise, they would be "like" products and any difference in taxation between them would be caught by the first sentence of Article III:2.

4.309 The European Communities states that the relationship between the two terms of Chile's test is also far from clear. Does Chile consider that tax distinctions based on "objective" differences are *per se* "neutral"? That proposition can be easily refuted. Many tax distinctions based on "objective" differences are demonstrably protectionist, both in purpose and in effect.

4.310 The European Communities asks the Panel to consider, for instance, the tax distinction made by Japan between shochu and whisky. That distinction is by no means a "subjective" one. There are "objective" differences between those two spirits, including differences in alcohol content which are even larger than those between whisky and pisco.¹⁷² If Chile's interpretation was upheld, Japan could re-introduce the same tax differentials that have already been condemned in two panel reports, simply by replacing the explicit distinction between shochu and whisky with a distinction based on alcohol content or on any other of the "objective" characteristics (or a combination of them) that differentiate shochu from whisky.

4.311 The European Communities alternatively asks the Panel to consider the hypothesis that a vodka producing country (say Finland) levied a tax based on the degree of optical density (i.e., the colour of the beverage), which results in the application of a 1000 % tax on "brown spirits" and a 1 % tax on "white spirits". Would that be a "neutral" tax distinction simply because it is based on an "objective" characteristic?

4.312 The European Communities argues that Chile itself has conceded implicitly that the "neutrality" of a tax distinction cannot be presumed *a priori*. In fact, as part of its discussion under the second element of Article III:2, Chile sets out to demonstrate why the New Chilean System is actually "neutral". However, if the neutrality of a tax distinction had to be ascertained already as part of the second element, the third element of Article III:2, second sentence, would become superfluous. This point is illustrated by Chile's First Submission, where the arguments made by Chile under the second element with respect to the alleged the "neutrality" of the New Chilean System are then repeated almost without variation in connection with the third element.

4.313 In conclusion, the European Communities states that it would agree that Article III:2, second sentence, does not prohibit tax distinctions between directly competitive or substitutable products which are "neutral". But the "neutrality" of tax distinction is not something which can be inferred from the mere fact that the tax distinction is based on differences on alcohol content or on any other "objective" product difference. The "neutrality" of tax distinction has to be established, on case-by-case basis and having regard to all relevant factors, under the third element of Article III:2, second sentence. In *Japan – Taxes on Alcoholic Beverages II*, the Appellate Body found that the panel had erred "in blurring the distinction between [the issue of whether the products were similarly taxed] and the entirely separate issue of whether the tax measure in question was applied so as to afford protection". The test put forward by Chile in this case incurs in the same mistake.¹⁷³

4.314 The European Communities further contests Chile's argument that in the New Chilean System "differentiation in taxation is based on alcohol content, not type of distilled spirit". This claim, however, involves an obvious fallacy. Each type of spirit is typically produced within a certain range of alcohol content. This difference has been recognised by Chile's regulations, which prescribe a different minimum alcohol content for each of the most common types of spirits. As a result, tax distinctions based on alcohol content lead necessarily to tax distinctions between types of spirits.

¹⁷² The European Communities notes that the most usual strength of shochu is 25°.

¹⁷³ Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II*, *supra.*, pp. 26-27.

4.315 The European Communities maintains that the New Chilean System ensures that the main types of imported spirits (whisky, gin, rum, vodka and tequila, all of which have a minimum alcohol content of 40°) are taxed at the highest rate possible: 47 %. Meanwhile, the vast majority of pisco (which has a minimum alcohol content of 30°) is taxed at the lowest rate possible: 27 %. Thus, it is indisputable that in the New Chilean System pisco and the other spirits in dispute are still not "similarly" taxed.

4.316 The European Communities further argues that *Japan – Taxes on Alcoholic Beverages II* stands for the proposition that the application of specific taxes in direct proportion to the volume of alcohol contained in each type of distilled spirit does not constitute "dissimilar" taxation. The underlying reasoning is that, in that system of taxation, the taxed product is not the spirituous beverage but the alcohol contained in the beverage.

4.317 In the view of the European Communities, this reasoning is not applicable in the case at hand. The measure in dispute is an *ad valorem* tax and not a specific tax. And it is calculated on the basis of the value of the beverage as a whole and not on the basis of the value of the alcohol content. Therefore, unlike the measures applied by Japan, it cannot be characterised as a tax on the alcohol content. For that reason, the European Communities considers that the Panel should compare the absolute rates applied to each spirit, rather than the rates per degree of alcohol contained in each type of spirit.

4.318 The European Communities argues that in any event, it has demonstrated that pisco and the other spirits are also "not similarly" taxed even if one compares the rates per degree of alcohol. Each degree of alcohol in whisky, gin, vodka, rum and tequila is taxed at a rate which is more than 50 % higher than the rate applied to each degree of alcohol in pisco of 35°.

4.319 The European Communities points out that Chile has acknowledged this tax differential, but claims that the lack of proportionality between differences in taxation and differences in alcohol content does not constitute "dissimilar" taxation. According to Chile, a difference in alcohol content between two types of spirits (however small) could justify any conceivable difference in taxation between them (no matter how large) that a Member may chose to apply. By way of justification, Chile argues that alcohol content is an "objective" product characteristic and that distinctions based on that criterion are always "neutral".

4.320 The European Communities maintains that Chile's position is refuted by *Japan – Taxes on Alcoholic Beverages I and II*. The second panel report is particularly clarifying in this regard. In that report, the panel based its conclusion that whisky and shochu were not "similarly" taxed on the fact that the tax rate per degree of alcohol applied to whisky of 40° was higher than the rate per degree of alcohol applied to shochu of 25°. This comparison would have been totally irrelevant if, as claimed by Chile, differences in alcohol content could justify non-proportional differences in taxation. If Chile's position was correct, the panel could not have reached the conclusion that shochu and whisky were not "similarly" taxed except by comparing the rates per degree of alcohol applied by Japan to whisky and shochu with the same alcohol content, something which the panel did not consider necessary to do.

4.321 Agreeing with Chile in that Article III:2, second sentence, does not prohibit tax distinctions between directly competitive or substitutable products which are "neutral," however, the European Communities argues that, contrary to Chile, it believes that the "neutrality" of a tax distinction is not something which can be presumed from the mere fact that the distinction in question is based on alcohol content or on any other "objective product difference". The "neutrality" of a tax distinction has to be established, on a case-by-case basis and having regard to all relevant factors, under the third element of Article III:2, second sentence.

4.322 The European Communities also contests Chile's invocation as authority for its sweeping proposition that tax distinctions based on differences in alcohol content never constitute "dissimilar taxation", of a somewhat obscure passage contained in the Panel Report on *Japan – Taxes on Alcoholic Beverages I*:

The Panel was unable to find that the differences as to the applicability and non-taxable thresholds of the *ad valorem* taxes were based on corresponding objective product differences (e.g., alcohol contents) and formed part of a general system of internal taxation equally applied in a trade-neutral manner to all like or directly competitive liquors (e.g., "alcohol taxes" equally applied to all alcoholic beverages).¹⁷⁴

4.323 The European Communities argues that the above passage, however, is inapposite for a number of reasons. The European Communities explains that first, it relates to the interpretation of the first sentence of Article III:2, a provision which has a different scope and structure. The test laid down by the panel is superfluous in the context of the second sentence of Article III:2, because tax distinctions between "directly competitive or substitutable products" are always permissible, provided that they are not applied "so as to afford protection".

4.324 The European Communities goes on to state that second, the meaning of the passage is notably ambiguous. The reading made by Chile is contradicted by several other passages in the same report where the panel stated very clearly that tax distinctions between "like" alcoholic beverages with different alcohol content may be compatible with the first sentence of Article III:2 to the extent that they can be explained as a non-discriminatory tax on the alcohol content:

The Panel was unable to find that these tax differentials corresponded to objective differences of the various distilled liquors, for instance that they could be explained as a non-discriminatory taxation of their respective alcohol contents.¹⁷⁵

It followed from the clear wording of Article III:2 that imported liquors "shall not be subject ... to internal taxes ... in excess of those applied ... to like domestic products". The Panel was of the view that this unqualified wording must not necessarily mean that there could never be any circumstances in which different tax treatment of "like products" was compatible with the General Agreement. The Panel noted, for instance, that GATT Article III:2 [*sic*] permitted the non-discriminatory taxation "of an article from which the imported product has been manufactured or produced in whole or in part", and that such a non-discriminatory alcohol tax on like alcoholic beverages with different alcoholic contents could result in different tax rates on like products.¹⁷⁶

4.325 The European Communities argues that finally, Chile's reading is incompatible with the findings of *Japan – Taxes on Alcoholic Beverages - II*, where the Appellate Body confirmed that the "aim-and-effect" of a tax distinction is irrelevant for the purposes of the first sentence of Article III:2.¹⁷⁷

¹⁷⁴ Panel Report on *Japan - Taxes on Alcoholic Beverages I*, *supra.*, para 5.9 b).

¹⁷⁵ *Ibid.*, para 5.9 a).

¹⁷⁶ *Ibid.*, para 5.9 d). See also para 5.13.

¹⁷⁷ Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II*, *supra.* See also Appellate Body Report on *European Communities – Regime for the Importation, Sale and Distribution of Bananas*, WT/DS27/AB/R, para. 241.

4.326 Further, the European Communities maintains that the statement made by the European Communities in *Japan – Taxes on Alcoholic Beverages II* which is cited by Chile has been taken out of context. In *Japan – Taxes on Alcoholic Beverages - II*, the proponents of the "aims-and-effect" test argued that the so-called "two-step" test put forward by Canada and the European Communities was too rigid. In response to a question from the Panel, the European Communities suggested that the two-step approach could be assorted of two "flexibilities". The first flexibility was to make a "narrow" interpretation of the term "like". The second "flexibility" amounted in practice to the creation of a praetorian exception for graduated systems, subject to certain conditions aimed at ensuring their neutrality. The passage quoted by Chile purports to describe the scope of the suggested second "flexibility". Eventually, the panel, and later the Appellate Body, accepted the first flexibility, but not the second one. In any event, the second "flexibility" did not offer an unqualified exception for all tax distinctions based on alcohol content. The passage quoted by Chile refers to "proportional" tax variations, which are "equally and uniformly applied" to both imported and domestic products. Chile's tax system does not satisfy any of those requirements. Furthermore, the second "flexibility" is unnecessary in the context of Article III:2, second sentence, because the third element ("so as to afford protection") already serves that function.

4.327 The European Communities then concludes that in any event, the passage invoked by Chile makes it clear that tax distinctions based on "objective product differences", including distinctions based on differences in alcohol content, cannot be presumed to be "neutral". Rather, it must be established in each particular case that they are "equally applied in a trade-neutral manner to all like or directly competitive liquors". As demonstrated by the analysis made by the European Communities under the third element of Article III:2, second sentence, Chile's measures do not meet this standard.

4.328 Also, the European Communities refers to Chile's citation of the following passage of *Japan – Taxes on Alcoholic Beverages I*:

Article III:2 does not prescribe the use of any specific method or system of taxation ... there could be objective reasons proper to the tax in question which could justify or necessitate differences in the system of taxation for imported and for domestic products.¹⁷⁸

The European Communities then argues that the passage is both irrelevant and misleading. It is irrelevant because the present dispute does not concern the application of two different taxation methods to domestic and imported products, but rather the application of a single taxation method which affords protection to domestic production.

4.329 The European Communities also explains that it is misleading because, read in isolation, it could suggest that the panel accepted that "objective" reasons could justify the application of different taxes to domestic and imported products. In reality, however, the point made by the panel was that the application of two different taxation methods to domestic and imported products (*in casu* the application of different methods for assessing the tax base) is not *per se* contrary to Article III:2. Rather, in order to establish a violation of that provision, the complainant has to demonstrate that the application of two different methods results in the imposition of a higher tax burden on imports than on domestic products. This becomes clear in the two sentences that follow the passage cited by Chile:

The Panel found that it could also be compatible with Article III:2 to allow different methods of calculation of price for tax purposes. Since Article III:2 prohibited only discriminatory or protective tax burdens on imported products, what mattered was, in

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

the view of the Panel, *whether the application of the different taxation methods actually had a discriminatory or protective effect against imported products.*¹⁷⁹

4.330 The European Communities points out that these two sentences have been omitted by Chile, but not in the citation of the same passage made by the Appellate Body in *Japan – Taxes on Alcoholic Beverages II*.¹⁸⁰ Significantly, the Appellate Body referred to this passage in the context of its discussion of the third element of Article III:2, second sentence, and not in connection with the second element.

4.331 The European Communities also contests Chile's invocation of the findings of the Panel Report on *United States – Taxes on Automobiles* with respect to a luxury tax applied by the United States on vehicles over a certain threshold value. That Panel Report, however, was never adopted because both the complainant and the defendant were dissatisfied with the panel's reasoning.

4.332 The European Communities further points out that although the Panel Report on *United States – Taxes on Automobiles* is based on the so-called "aims-and-effects" approach, according to which whether or not two products are "like" depends on whether the regulatory distinction has the purpose and the effect of affording protection to domestic production, this approach was rejected by the panel¹⁸¹, and then by the Appellate Body in the *Japan – Taxes on Alcoholic Beverages II* case.¹⁸² The Appellate Body has confirmed its rejection of that approach in *EC – Measures affecting the Importation, Sale and Distribution of Bananas*.¹⁸³

4.333 Moreover, the European Communities argues that even under the "aims-and-effects" approach, the mere fact that a tax distinction is based on an "objective" criterion is not sufficient to exclude *per se* the application of Article III:2. In *United States – Taxes on Automobiles* the panel examined whether *in casu* the tax distinction had the "purpose" and the "effect" of affording protection to domestic production. According to the European Communities, Chile's strategy in the present case, however, is to prevent the Panel from conducting that type of analysis by arguing that since the products are "similarly" taxed, it is not necessary for the Panel to look at the third element of Article III:2, second sentence.

4. Reach of Japan/Korea – Taxes on Alcoholic Beverages cases

4.334 **Chile disagrees** with the EC's evident determination to portray the New Chilean System as a replication of the tax systems of Japan and Korea that previous panels found inconsistent with Article III:2, second sentence. The New Chilean System is fundamentally different from the Japanese and Korean tax systems for alcoholic beverages, both of which discriminated based on type of distilled spirits and both of which favoured a type that was and could be only supplied domestically for all practical purposes. By contrast, the New Chilean System does not differentiate by type of distilled spirit, but instead applies an **identical** tax scale, imposing an **identical** *ad valorem* tax depending on degree of alcohol content to all distilled spirits (except beer and wine) regardless of type and whether imported or domestic. Ironically, the European Communities asks the Panel to condemn the Chilean system by analyzing that system in terms of effects on a subjective classification system (i.e., type) that Chile explicitly abandoned as a matter of tax classification in enacting Chilean Law 19,534.

¹⁷⁹ Panel Report on *Japan - Taxes on Alcoholic Beverages I*, *supra.*, para 5.9 c). [emphasis added by the European Communities].

¹⁸⁰ Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II*, *supra.*, p. 29.

¹⁸¹ Panel Report on *Japan - Taxes on Alcoholic Beverages II*, *supra.*, para. 6.18.

¹⁸² Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II*, *supra.*, pp. 15-23.

¹⁸³ Appellate Body Report on *European Communities – Regime for the Importation, Sale and Distribution of Bananas*, *supra.*, para. 241.

4.335 Chile contends that the EC effort to wrap this case in the mantle of successful challenges of the Korean and Japanese systems fails because it ignores fundamental differences between the cases and the systems. The Panel should reject the EC's unjust and ill-founded effort to stretch prior rulings in ways that do not conform with the language, practice, or intent of Article III:2.

4.336 Chile explains that while there are many differences between the Japanese and Korean cases and this case involving Chile, the most fundamental difference is that the systems at issue in the Japanese and Korean cases both taxed by type of distilled spirits, whereas the New Chilean System taxes all types identically, according to alcohol content and value.

4.337 Chile maintains that the European Communities tries to avoid this distinction by ignoring it. Thus the European Communities starts off its case with a lengthy argument about whether different distilled spirits are directly competitive or substitutable. That issue was critical in the Japan and Korea cases, precisely because those tax systems imposed different taxes according to the type of distilled spirit. Japan and Korea each created ten or more tax categories, based on different types of distilled spirit, each bearing its own separate rate or scale of taxation, with *shochu* in Japan and *soju* in Korea having the lowest rate or scale of taxation. There was virtually no doubt that the differences in taxation were more than *de minimis* and that imports had no prospect of benefiting from the lowest rates of taxation (since *shochu* and *soju* were effectively not imported). Thus the only critical question under Article III:2, second sentence, was whether the types of products taxed at a low rate were directly competitive or substitutable with the types taxed at higher rates.

4.338 In the view of Chile, the New Chilean System, however, does not so differentiate by type. That is why Chile has repeatedly pointed out that whether different types of spirits are directly competitive or substitutable in the Chilean market is essentially irrelevant under the New Chilean System, since that system does not make distinctions by type. Chile does not, in fact, consider that pisco is directly competitive or substitutable with whisky for the reasons stated in previous submissions by Chile. However, Chile does not rely on the differences between pisco and other types of distilled spirits in claiming the consistency of the New Chilean System with Article III:2, because the system does not impose taxes based on type.

4.339 According to Chile, the European Communities tries to obscure this fundamental difference by arguing that the effect of the New Chilean System is to tax types of distilled spirits that are customarily or by law sold at higher degrees of alcohol strength at higher *ad valorem* rates than types sold at lower alcohol strengths. Undoubtedly that is true, but that result does not infringe Article III:2. The reason the Korean and Japanese systems were found inconsistent with GATT 1994 was not because tax distinctions based on type of distilled spirit *per se* violate Article III:2. The core problem with those systems was that the effect of the particular type distinctions in those systems was to favor a particular product that was effectively not imported, and thus the type distinction had the effect of discriminating in favor of an almost exclusively national product.

4.340 Chile further argues that the critical flaw in the EC's analysis arises from the EC's effort to stretch the analysis of past panels considerably beyond any past precedents, including the Japan and Korea alcoholic beverage tax cases. The panels in the Japan and Korea cases were dealing with discrimination based on the subjective concept of type of distilled spirits, where products are distinguished according to how and sometimes where they are made. The use of those subjective criteria had the direct effect of limiting the benefits of the most favorable tax to a type of product which was produced locally and which, in practice, could not be imported into those countries.

4.341 Chile maintains that faced with an entirely different situation with the New Chilean System, the European Communities asks this Panel to go one gigantic and impermissible step further than past panels. It takes a Chilean System that differentiates by the objective standard of alcohol content, and asks the Panel to view that system in terms of its effect on different types of distilled spirits. The

European Communities argues as though previous panels had established a rule that Article III requires no tax discrimination based on types of distilled spirits, and therefore that distinctions that *de facto* have different impacts on different types are then also inconsistent with Article III:2, or at least should be so considered.

4.342 Chile emphasizes that beyond the point that nothing in the Japan or Korea cases mandates such a further extension of the holding of those cases, there are very significant legal, logical and practical differences between systems such as those of Japan and Korea that codify a distinction based on a subjective and qualitative concept such as "types" of products and systems based on objective criteria applied equally to all products that are directly competitive or substitutable, regardless of type. According to Chile, the European Communities tries to give the objectively based Chilean system an aura of subjectivity by analyzing the New Chilean System on the basis of its effect on different subjective types of products. Then, ignoring or dismissing inconvenient facts – the significant and increasing quantity of pisco and other products that will be subject to high taxes and the actual and potential trade in low-tax products – the European Communities claims that the *de facto* discrimination by type that the European Communities claims to see in turn constitutes a *de facto* discrimination based on nationality. If this unprecedented theory is sustained, all that will be required to find a violation of Article III:2 will be to conjure the right kind of subjective classification system that will validate a case based on differential effects of an objective tax system. It would not even affect the analysis if the more heavily taxed type of product is produced in substantial quantities in the taxing country as well as imported, since that fact existed in the Japan case, but did not affect the Appellate Body's ruling.

4.343 Chile argues that many of the claims of the European Communities are absolutely wrong since the new Chilean taxation system for alcoholic beverages is based on an objective criterion and the fact that the tax paid by each product is based in two factors: alcohol content and price (i.e., *ad valorem*) of the product, regardless from its type, origin and labeling.

4.344 According to Chile, the European Communities confuses the issue when pointing out that the system is conceived so that pisco, which has a lower alcohol content, will pay less taxes, while other imported products will pay higher taxes. The truth and the correct and fair way of describing the New Chilean System is that the system is conceived so that pisco having a low alcohol content, as well as all other domestic or imported spirits of low alcohol content, will be subject to lower tax rates, while pisco with high alcohol content, as well as all other domestic or imported spirits of high alcohol content, will be subject to higher tax rates. Consequently, the higher or lower tax rate is solely determined by the alcohol content of the product and not by its origin, as the European Communities seems to suggest. In any system within this "philosophy" (i.e., to tax based on alcohol content), the result will be that those products with less alcohol will be subject to a relatively lower tax also.

4.345 Chile explains that concerning the *ad valorem* component of the new system, it has opted to maintain an *ad valorem* system since in an economy as open as the one in its country, competition factors, such as product price relationships, have to be preserved. The *ad valorem* taxation system does not alter this competitive attribute of products (i.e., price relationships), as opposed to those in which an absolute value is determined according to alcohol content, thus introducing a degree of distortion biased for the benefit of products of higher prices since the tax is a lower proportion of its final price.

4.346 Chile further argues that *ad valorem* taxes are not illegal simply because domestic products are cheaper than imports, and thus bear less tax per unit. To take an example, EC Member States impose *specific* taxes on distilled spirits that, measured in *ad valorem* proportional terms, result in low-priced Chilean products bearing much greater proportionate taxes than spirits that the EC considers directly competitive or substitutable. The following chart demonstrates how the tax system

of four Member States all impose these proportionately higher taxes on Chilean pisco than on their own domestic products.

4.347 As an example, Chile presents Table 28¹⁸⁴ which compare the specific tax on pisco of 35°, pisco of 40°, whisky 43°, cognac VSOP, brandy Fundador and brandy Carlos I in some EC Member States, and Table 29¹⁸⁵ which also compares the specific tax applied in these EC Member States in *ad valorem* terms.

Table 28¹⁸⁶

SPECIFIC TAX TO ALCOHOLIC BEVERAGES IN SOME EC MEMBER STATES (US\$/lt)							
MEMBER STATES	Pisco	Pisco	Whisky	Whisky	Cognac	Brandy	
	35°	40°	43°	43°	VSOP	Fundador	Carlos I
Spain	2.66	3.04	3.26	3.26	3.04	2.88	3.04
Great Britain	11.37	13.00	13.97	13.97	13.00	12.35	13.00
France	6.34	7.05	7.47	7.47	7.05	6.76	7.05
Germany	5.60	6.40	6.88	6.88	6.40	6.08	6.40

Table 29¹⁸⁷

SPECIFIC TAX TO ALCOHOLIC BEVERAGES IN SOME EC MEMBER STATES MEASURED IN <i>AD VALOREM</i> PROPORTIONAL TERMS (%)							
MEMBER STATES	Pisco	Pisco	Whisky	Whisky*	Cognac*	Brandy*	
	35°	40°	43°	43°	VSOP	Fundador	Carlos I
Spain	92.9	78.1	57.3	29.8	9.6	37.4	13.4
Great Britain	397.9	334.2	245.1	127.5	40.9	159.9	57.2
France	221.9	181.2	131.0	68.1	22.2	87.6	31.0
Germany	195.9	164.6	120.7	62.8	20.2	78.8	28.2

Notes: Prices in US\$/lt CIF/ex-factory: Pisco 35°: US\$ 2.86; Pisco 40°: US\$ 3.89; Whisky 43°: US\$ 5.70; Whisky* 43°: US\$ 10.96; Cognac Remy VSOP* 40°: US\$ 31.74; Brandy Fundador* 38°: US\$ 7.72; Brandy Carlos I* 40°: US\$ 22.72.
 *Prices: Duty Free

4.348 According to Chile, this shows that the specific tax on alcoholic beverages applied in these EC Members States is relatively higher to those alcoholic beverages with lower alcohol content. Chile indicates that it is not asking the Panel to deal with a new complaint, but rather to demonstrate that neutral, objective systems can have these disproportionate effects shown, without infringing Article III.

4.349 Further, Chile notes that European Communities complains that the New Chilean System is based on both alcohol content and value, which the European Communities terms a hybrid. The real EC complaint here appears to be that Chile should copy the EC Member State systems, which apply a specific tax per degree of alcohol. Again, Chile has noted that *ad valorem* taxes have long been endorsed by the WTO and by economists, whereas specific taxes are much more likely to distort competition. Further, there is no element of Article III that forbids using both objective criteria, which in tandem also serve the objective of making the New Chilean System materially more

¹⁸⁴ Chile Oral Statement at the First Substantive Meeting, p. 4.

¹⁸⁵ Ibid.

¹⁸⁶ Chile Oral Statement at the First Substantive Meeting, p. 4.

¹⁸⁷ Ibid.

progressive than using a flat *ad valorem* rate or worse, the EC's specific tax system, which would be that much more regressive.

4.350 **The European Communities replies** that Chile insists that its New Chilean System is different from the Japanese tax system and the Korean tax system. In reality, however, the differences are only superficial.

4.351 The European Communities states, in response to Chile's claim that the New Chilean System does not differentiate "by type," that a trick as old as protectionism is to base regulatory distinctions on product characteristics which distinguish indirectly between domestic and imported products. Chile's system is slightly more sophisticated than the Japanese system or the Korean system, but no less protective in both purpose and effect.

4.352 The European Communities claims that the alcohol content thresholds chosen by Chile evidence that the New Chilean System has been devised so as to replicate the effects of the explicit tax distinctions between "types" made in the old system. The minimum alcohol content of most imported spirits is 40°, whereas 35° is the most usual alcohol content of *pisco especial*, which together with *pisco tradicional* of 30° accounts for more than 90 % of the sales of pisco. As confirmed by Chile's responses to the questions posed by the Panel, there can be no rational explanation for choosing precisely those two thresholds, other than affording protection to pisco.

4.353 The European Communities contests Chile's argument that another "fundamental" difference would be that its New Chilean System is based on "objective" criteria, whereas the Japanese and the Korean system were based on "subjective" criteria. Chile, however, never explains what distinguishes an "objective" criterion from a "subjective" one. The differences between whisky and shochu did not exist only in the minds of the Japanese taxmen. There are "objective" differences between shochu and whisky, including differences in alcohol content which are even larger than those between pisco and whisky. Those "objective" differences, however, were not considered as a valid justification for taxing whisky more heavily than shochu.

4.354 The European Communities also contests Chile's argument that shochu and soju were "effectively not imported" into Japan and Korea, respectively. This misrepresents the facts of those two cases. Shochu and soju were imported in relatively small quantities, compared to domestic production, but neither of them was an "inherently" domestic product. For example, in 1995, imports of shochu accounted for 2.4 % of the sales of shochu in Japan.¹⁸⁸ In comparison, in 1996 imports into Chile of low strength liqueurs (the only imported products which in practice will benefit from the lowest tax rate) represented less than 0.4 % of the domestic sales of spirits with a minimum alcohol content of 35 % or less, as shown in Table 19 above. Thus, the New Chilean System is more protective than the Japanese system by Chile's own standard.

4.355 The European Communities maintains that Chile's strategy in this case is to divert the Panel's attention from the examination of Chile's own tax system. Chile attempts to do so by focusing the discussion on other tax systems (both real and hypothetical), which are fundamentally different from the New Chilean System. With the same purpose, Chile tries to focus the debate on a number of superficial differences between this case and previous cases.

5. "Direct Proportionality" Argument

4.356 **The European Communities also points out** that the two panel reports on *Japan – Taxes on Alcoholic Beverages I* and *II* stand for the proposition that the application of specific taxes in direct proportion to the alcohol contained in each type of distilled spirit does not constitute "dissimilar"

¹⁸⁸ Panel Report on *Japan - Taxes on Alcoholic Beverages II*, *supra.*, para 4.175.

taxation of the spirits. The underlying reasoning is that, in such a system of taxation, the taxed product is not the spirit but the alcohol contained in the beverage. For example, the European Communities applies a uniform specific tax per hectolitre of pure alcohol to all the products containing ethyl alcohol, including, but not limited to, distilled spirits falling within HS 2208.¹⁸⁹

4.357 The European Communities maintains that this reasoning does not apply in the case at hand. The measure applied by Chile is an *ad valorem* tax applied on the value of the beverage as a whole and not on the value of the alcohol content. Moreover, the value of the beverage is not directly related to the value of the alcohol content. Therefore, Chile's measure cannot be characterised as a tax on the alcohol content. For that reason, the European Communities considers that, in order to determine whether pisco and the other spirits are "similarly taxed", the Panel should compare the rates per bottle of each spirit, and not the rates per degree of alcohol.

4.358 The European Communities claims that in any event, it has shown that pisco and the other spirits are also "not similarly" taxed when one compares the rates per degree of alcohol. Specifically, each degree of alcohol contained in a bottle of whisky, gin, rum, vodka or tequila is taxed at rate which is more than 50 % higher than the rate applied to each degree contained in a bottle of *pisco especial*.

4.359 The European Communities notes that Chile has acknowledged that the rates per degree of alcohol vary from one spirit to another, but that it claims that the lack of proportionality between differences in taxation and differences in alcohol content does not amount to "dissimilar" taxation. In other words, according to Chile, if there is a difference in alcohol content, however small, between two spirits, then no conceivable tax differential which a Member may see fit to apply can be considered as "dissimilar" taxation of those spirits.

4.360 In the view of the European Communities, Chile's position is logically untenable. If the taxed product is the alcoholic beverage, then one should compare the rates per unit of beverage volume, irrespective of their alcohol content. On the other hand, if the taxed product is the alcohol content, the comparison should be made between the rates per unit of alcohol volume, regardless of the beverage in which it is contained.

4.361 The European Communities notes that in any event, as shown in Table 30, in the amended ILA the tax rate per degree of alcohol is not uniform but varies from product to product. Each degree of alcohol in whisky, gin, vodka, rum and tequila is taxed at 1.175 % while each degree of alcohol in pisco of 35° is taxed at only 0.771 %. Thus, pisco and the main types of imported spirits are not "similarly" taxed even if the comparison is made by reference to their alcohol content.

¹⁸⁹ See Council Directive 92/83/EEC, of 19 October 1992 (OJ No L 316 of 31.10.92) and Council Directive 92/84/EEC, of 19 October 1992 (OJ No L 316 of 31.10.92).

Table 30¹⁹⁰

Alcohol content	<i>Ad valorem</i> rate	Percentage points per degree of alcohol
15°	27 %	1.8 %
20°	27 %	1.35 %
25°	27 %	1.08 %
30°	27 %	0.9 %
35°	27 %	0.771 %
38°	39 %	1.026 %
40°	47 %	1.175 %
43°	47 %	1.093 %

4.362 The European Communities also points out that if the rate per degree of alcohol was the same for all spirits as the rate currently applied to pisco of 35°, the resulting *ad valorem* rates would be as follows:

Table 31¹⁹¹

Alcohol content	Current <i>ad valorem</i> rate	<i>Ad valorem</i> rate if the rate per degree of alcohol was 0.771 %
15°	27 %	11.57 %
20°	27 %	15.42 %
25°	27 %	19.28 %
30°	27 %	23.13 %
35°	27 %	27 %
38°	39 %	29.30 %
40°	47 %	30.84 %

¹⁹⁰ EC First Submission, Table 21.

¹⁹¹ Ibid., Table 22.

4.363 The European Communities then concludes that if the taxed product is the alcoholic beverage, then one should compare the rates per unit of beverage volume, irrespective of their alcohol content. On the other hand, if the taxed product is the alcohol content, the comparison should be made between the rates per unit of alcohol volume, regardless of the beverages in which it is contained.

4.364 **In rebuttal, Chile notes** that the European Communities implies that it could accept the *ad valorem* and alcohol content standards of the Chilean law, if only the taxes were proportional. Then, Chile argues that there is no rule of proportionality in the WTO and, if there were, the European Communities would be in violation of its own rule because wine and beer are taxed less per degree of alcohol than whisky and other distilled spirits. Indeed, the EC's argument in this respect with regard to Chile is remarkably similar to the complaint of the Scotch Whisky Association about tax systems that favor wine and beer in Member Countries of the European Union. There are many other "non-proportional" taxes, *including all specific taxes*, for example. Furthermore, the European Court of Justice upheld a non-proportional tax on engine displacement under the EC's own national treatment provisions. The United States also taxes wine and beer at much lower rates per degree of alcohol, using a system that also produces large variations in tax for small differences in alcohol content of its wines.¹⁹²

4.365 Chile points out that ultimately, the European Communities itself seems to recognize that Article III does not require taxes or regulations to have equal effects by all standards of measurement, as the European Communities ultimately appears to rely on a theory that the deficiency of the New Chilean System is not that the taxes vary by alcohol strength, but rather that the tax does not vary in direct proportion to alcohol strength, as shown for example in Tables 30 and 31 above. Chile does not deny the veracity of those charts, but Chile strongly disagrees that Article III requires a rule of direct proportionality with respect to alcoholic beverage taxes.

4.366 Chile notes that the European Communities appears to suggest that decisions on *Japan - Taxes on Alcoholic Beverages I* and *II* support the EC proposition that taxes employing an alcohol content standard must establish tax rates directly proportional to the degree of alcohol in order not to constitute dissimilar taxation. In fact, the panels in those cases did not decide that issue. The panels only said that taxation must be based on objective criteria, and that Japan could not use a different scale of alcohol-based taxation for different types of directly competitive or substitutable alcoholic beverages, but the panels did not say that taxes must be directly proportional to alcohol strength.

4.367 Chile maintains that GATT Article III:2 has never been interpreted to require such a direct proportionality rule. As Chile has already noted above, the Japanese systems were faulted for establishing significantly different tax scales for different types of distilled spirits that the panels held to be like, directly competitive or substitutable. The panels did not find fault, however, with the lack of direct proportionality to liquor content.

4.368 **The European Communities replies** that contrary to Chile's protestations that this issue has not been decided by previous panels, Chile's position is refuted by the findings of the two Panel Reports on *Japan - Taxes on Alcoholic Beverages I* and *II*. The second panel report is particularly clear in this regard. In that report, the panel based its conclusion that whisky and shochu were not "similarly" taxed on the fact that the rate per degree of alcohol applied to whisky of 40° was higher than the rate per degree of alcohol applied to shochu of 25°.¹⁹³ This comparison would have been

¹⁹² 26 U.S.C.A. § 5001.

¹⁹³ The European Communities notes that under Japan's Liquor Tax Law, the tax rate varied within each of the four tax categories ("shochu", "whisky/brandy", "spirits" and "liqueurs") according to alcohol content. For example, the tax rate on shochu B of 25° was ¥102,100 per kiloliter and the rate on shochu B of 40° ¥284,100 per kiloliter. Shochu is produced within the range of 20° to 45°, but 25° is the most usual strength.

totally irrelevant if, as claimed by Chile, differences in alcohol content could justify non-proportional differences in taxation. If Chile's position was correct, the panel could not have reached the conclusion that shochu and whisky were not "similarly" taxed except by comparing the rate per degree of alcohol applied by Japan to whisky of 40° and to shochu of 40°, something which the panel did not consider necessary to do.¹⁹⁴ The European Communities maintains that similarly, the panel reached the conclusion that vodka was taxed "in excess of" shochu by comparing the rate per degree of alcohol applied to vodka of 38° to the rate per degree of alcohol applied to shochu of 25° and not the rate per degree of alcohol applied to shochu of 38°¹⁹⁵

4.369 **Chile further responds** that it should also be born in mind that requiring a direct proportionality rule is not only unprecedented and unwarranted under the plain language of Article III:2, but it serves no valid policy purposes not already served simply by requiring objective standards. A large benefit for international trade in having objective standards such as the alcohol strength criterion of the New Chilean System is that domestic and foreign producers have the ability to adapt their production to reduce the tax or regulatory burden, if they so choose. As discussed below under the third element of the Article III:2 test, the New Chilean System allows foreign producers, if they so choose, to dilute their product to qualify for lower levels of Chilean taxes. While in some cases that may be inconvenient for exporters in much the way different national labeling or packaging requirements can be inconvenient, Article III does not require harmonization of standards to the convenience of large global exporters.

4.370 In the view of Chile, thus, the European Communities recognizes the right to differentiate products based on objective criteria such as the alcohol content of a beverage and in doing so implement a neutral based system that does not infringe Article III. Chile has enacted such a law based on the very same objective criteria that the European Communities has recognized as valid: the alcohol content of the various spirits, which does not discriminate among the various domestic and foreign participants.

4.371 Chile argues that similar views have been expressed before the European Court of Justice ("ECJ"). The ECJ in Case 170/78, *Commission v United Kingdom*, 1983 ECR 2265 noted that:

[T]he Commission has recommended that spirits should be charged at a higher rate of duty according to alcoholic strength than liqueur wines. It appears, therefore, to have accepted that there are social reasons for imposing a relatively higher rate of taxation on beverages with a higher alcoholic content.¹⁹⁶

4.372 Chile reiterates that the New Chilean System does not make distinctions based on type of distilled spirits, but rather taxes every distilled spirit (except wine and beer) according to the same scale based on alcohol content and value. The European Communities uses a different objective scale for taxation of alcoholic beverages, levying a specific tax per degree of alcohol content for distilled spirits. Both the Chilean and EC systems by some measures discriminate against products based on price and alcohol content. *Ad valorem* systems, measured by specific rate per volume unit, fall most heavily on high priced goods, but economists agree that *ad valorem* systems are fairest in preserving competitive relationships. Specific rate taxes by comparison distort competition in favor of high price goods, if measured on an *ad valorem* basis.

4.373 According to Chile, the European Communities continues to attack the New Chilean system based on an unfounded theory that taxation based on alcohol content must be proportional. In some respects, the EC's argument seems to be motivated by an effort to make the EC's own tax system into

¹⁹⁴ Panel Report on *Japan - Taxes on Alcoholic Beverages II*, *supra.*, paras. 6.33 and 2.3.

¹⁹⁵ *Ibid.*, paras 6.24 and 2.3.

¹⁹⁶ The ECJ in Case 170/78, *Commission v United Kingdom*, 1983 ECR 2265.

a fixed GATT rule, as the European Communities insists on the use of not just directly proportional but specific taxes. There is no basis for such a claim. Chile has already pointed out that the European Communities does not even follow its own rule of proportionality with respect to beer and wine. The U.S. system for wine is even less proportionate.

4.374 Chile contends that if the EC's rule is applied to the effect that tax rates must be constant per degree of alcohol in order to meet the non dissimilar taxation test, it follows that an *ad valorem* flat rate would breach that test, as it shown in Table 32.

Table 32¹⁹⁷

TAX PER DEGREE OF ALCOHOL
 ASSUMING A 30% FLAT *AD VALOREM* RATE

Alcohol Content	Tax per degree of alcohol
25°	1.20 %
30°	1.00 %
35°	0.86 %
40°	0.75 %
45°	0.67 %

4.375 Chile maintains that such a proportionality test would invalidate luxury taxes that fall more heavily on luxury goods, or more lightly on low-priced staples, since such taxes are unlikely to be directly proportionate, which would be contrary to their very purpose.

4.376 Chile states that while the EC practices are not at issue, it hopes that the broader perspective of the Panel will lead it to reject the EC's insistence on a proportionality test and preference for specific duties as the preferred or only analytical perspective for assessing compliance with Article III of the GATT 1994.

4.377 According to Chile, both the EC and Chilean systems treat wine and beer separately. Chile taxes beer and wine relatively higher, measured in terms of degrees of alcohol, and the European Communities taxes wine and beer lower per degree of alcohol.

4.378 Chile notes that in another effort to bolster its complaint, the European Communities argues at several points that the *Japan - Taxes on Alcoholic Beverages II* case settles the issue whether there can be non-proportionate increases in tax based on alcohol content. Japan's system taxed shochu and whisky according to two very different scales of specific taxes, which significantly favoured shochu over whisky. Contrary to the EC's rather surprising claim, the panel did not reject the Japanese system because of a non-proportionate distinction in tax per degree of alcohol content, but rather because the scale for two different types of spirit was entirely different and advantageous only and at all points to shochu.

4.379 Chile further maintains that it is likewise inconceivable that members of the WTO, particularly developing country members, thought or think that, in joining the WTO and accepting

¹⁹⁷ Chile Oral Statement at the Second Substantive Meeting, Table I.

thereby the obligations of Article III:2, they were foregoing the right to use fiscal policy tools such as luxury taxes or exemptions or reduced taxes for goods purchased primarily by poor consumers, even if such policies result in higher taxes on many imports than on many like or directly competitive products.

4.380 In the view of Chile, the kind of flawed interpretation proposed by the European Communities in this case would set a bad precedent for not just alcoholic beverage cases, but also for other cases in which countries differentiate in the application of internal taxes on the basis of objective criteria. For example, virtually any luxury tax will have the effect of taxing high priced products more, even proportionately more than low-priced goods. Borrowing one of the examples from the Panel's questions, a Boss suit is surely as substitutable with a suit sold in a discount store as Scotch whisky is with Pisco Corriente. The EC's analysis would therefore prohibit a luxury tax on high priced suits, if most taxed suits were imported and there was substantial production of untaxed suits domestically. An even more closely analogous case would be an exemption from tax for low-price cooking oil, which would inevitably result in olive oil bearing a higher tax than, for example, palm oil or soybean oil. Such a tax would be illegal under the EC's analysis of Article III, and no exemption would save it.

4.381 Chile further argues that similarly, horsepower or engine displacement taxes, both of which have been common in Europe, would also breach Article III, if, as a result, some types of imported vehicles were treated less favorably than some types of vehicles predominantly produced domestically. Under the EC's theory, the United States and Canada would have justifiable complaints against the EC Member States because such taxes result in imported types of vehicles bearing higher taxes than domestic types.

4.382 Chile emphasizes that the New Chilean System does explicitly impose taxes according to alcohol content. However, that kind of objectively based discrimination, like discrimination by horsepower, engine displacement, or (in luxury tax systems) value, has not been considered to violate Article III:2. Yet, by the EC's logic, if it could be shown, for example, that an engine displacement tax resulted in higher taxes on, for example, sport utility vehicles that were largely imported, and lower taxes on small commuter cars that were largely produced domestically, then the engine displacement tax would become inconsistent with Article III:2 for distinguishing in its effects between types of directly competitive or substitutable vehicles.

4.383 Chile further puts forth that the European Communities itself does not observe a rule of direct proportionality for its own alcoholic beverages. Many EC Member States impose proportionately much lower taxes per degree of alcohol on beer and wine than on distilled spirits. The Scotch Whisky Association shows the following discrepancy in tax per degree of alcohol in various Member States of the European Communities:

Table 33¹⁹⁸

Proportionality of taxes per degree of alcohol on several The European Communities members

	Austria	Belgium	Denmark	Finland	France
Wine	Nil	426	856	2,162	30
Beer	347	425	780	2,888	257
Spirits	723	1,651	3,674	5,097	1,440
	Germany	Greece	Ireland	Italy	Luxembourg
Wine	Nil	Nil	2,559	nil	Nil
Beer	196	309	2,049	351	197
Spirits	1,297	999	2,847	648	1,035
	NL	Portugal	Spain	Sweden	UK
Wine	441	Nil	Nil	2,937	1,911
Beer	424	275	168	1,746	1,619
Spirits	1,497	814	686	5,955	2,843

(ECU per hectoliter of pure alcohol)¹⁹⁹

4.384 Chile notes that it cites this chart not to criticize the EC Member State tax systems nor to argue that beer and wine, which are not at issue in this dispute, should be regarded as competitive or substitutable products (though it is very clear that the Scotch Whisky Association believes that to be the case and is promoting arguments in that regard that are remarkably similar to the EC's arguments in this dispute). Rather, Chile refers to the chart to demonstrate that even the European Communities (despite the Scotch Whisky Association) does not really believe in a rule of direct proportionality for alcohol taxes. It might be added that tax systems of other countries exempt low value items from some forms of indirect taxes, such as low cost clothing or food. Luxury taxes and other kinds of progressive taxes similarly are particularly likely to have substantial effects on imports -- but such taxes are not considered to violate Article III merely because of a lack of direct proportionality.

4.385 **The European Communities notes** that Chile incorrectly argues that the fact that the EC Member States apply different rates per degree of alcohol to wine, beer and spirits involves a "recognition" by the European Communities that tax differentials do not have to be proportional to alcohol content. Contrary to what appear to be Chile's expectations, the European Communities does not consider it necessary to deny that wine, beer and spirits are not "similarly" taxed in the European Communities. It is self-evident from the table produced by Chile that they are not. This, however, is far from constituting *per se* a violation of Article III:2, as Chile implies. To begin with, it would have to be established that wine, beer and spirits are "directly competitive or substitutable" products,

¹⁹⁸ Chile First Submission, Table 3.

¹⁹⁹ The Scotch Whisky Association, *Bulletin Board - Case for Taxation Reform* (visited 24 Sept. 1998) <<http://www.scotch-whisky.org.uk/bb-txrfm.htm>>.

something which could be rather difficult, especially by Chile's own strict standard. Even then, it would still be necessary to show that the tax differentials afford protection to the EC domestic production. One may suspect that the very successful Chilean wine exporters would not subscribe the argument that, by taxing more heavily whisky than wine, the United Kingdom affords protection to its non-existent production of wine.

4.386 The European Communities also notes that Chile states the following in support of its allegation that the European Communities has "recognised" that the application of taxes that do not vary in proportion to alcohol content does not constitute dissimilar taxation:

The ECJ in case 170/78, *Commission v. United Kingdom*, 1983 ECR 2265 noted that:

... the Commission has recommended that spirits should be charged a higher rate of duty according to alcoholic strength than liqueur wines. It appears, therefore, to have accepted, that there are social reasons for imposing a relatively higher rate of taxation on beverages with a higher alcohol content.

4.387 The European Communities contests that to begin with, this is not something which the ECJ said. Instead, this was an argument made by the United Kingdom, the defendant in that case. In any event, the quoted passage does not support Chile's position. The quoted statement argues in favour of imposing a higher rate on spirits than on liqueurs "for social reasons". It does not argue that doing so would not constitute "dissimilar" taxation. To the contrary, to the extent that it refers to a "higher rate of taxation" the quoted statement admits explicitly the obvious fact that under the proposed system liqueurs and spirits would not be "similarly" taxed.

4.388 The European Communities also states that for the same reasons, the arguments drawn by Chile from the fact that some EC Member States apply car taxes that vary according to horsepower are also irrelevant.²⁰⁰ If a country applies higher taxes to large cars than to small ones, then it is indisputable that large cars and small cars are "not similarly" taxed. A different matter is whether small cars are "directly competitive or substitutable" with large cars. And still a different matter, whether applying higher taxes to large cars "affords protection to domestic production".

4.389 The European Communities goes on to argue that in this connection, it is worth noting that, contrary to Chile's assertions, the European Court of Justice ("ECJ") has never given an unconditional endorsement to the application of car taxes linked to engine power. The ECJ has ruled that those taxes may be compatible with Article 95 of the EC Treaty provided only that they are "free from any discriminatory or protective effect".²⁰¹ In a number of decisions, the ECJ has found that the application of car taxes linked to engine power was contrary *in casu* to Article 95 because it afforded protection to the domestic car production of the Member State concerned. The tax systems condemned by the ECJ had features which made them very similar to Chile's liquor tax system, such as arbitrary thresholds or disproportionately steep increases beyond the point where there is no significant domestic production.²⁰²

²⁰⁰ The European Communities notes that the suggestion to the effect that the US "is more likely" to produce cars with higher horsepower than the European Communities is simply wrong. Most Mercedes, BMWs and Jaguars, as well as Porsches or Ferraris, are still assembled in the European Communities.

²⁰¹ See e.g. the Judgement of 9 May 1985, Case 112/84, *Michel Humblot v. Directeur des services fiscaux* (ECR 1985, pages 1367-1380); and the Judgement of 17 September 1987, Case 433/85, *Jacques Feldain v. Directeur des services fiscaux du departement du Haut-Rhin* (ECR 1987, p. 3521).

²⁰² The European Communities points out that for example, in *Humblot* (para. 16) the ECJ ruled that: "Article 95 of the EEC treaty prohibits the charging on cars exceeding a given power rating for tax purposes of a special fixed tax, the amount of which is several times the highest amount of the

D. "SO AS TO AFFORD PROTECTION TO DOMESTIC PRODUCTION"

1. Overview

4.390 **The European Communities first notes** that in *Japan - Taxes on Alcoholic Beverages II*, the Appellate Body provided the following approach for establishing whether dissimilar taxation of directly competitive or substitutable products is applied "so as to afford protection to domestic production":

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

Although it is true that the aim of a measure may not be easily ascertained, nevertheless its protective application can most often be discerned from the design, architecture and revealing structure of a measure. The very magnitude of the dissimilar taxation in a particular case may be evidence of such protective application Most often, there will other factors to be considered as well. In conducting this inquiry, panels should give full consideration to all the relevant facts and all the circumstances in any given case.²⁰³

4.391 The European Communities goes on to state that an example of how this approach is to be applied is provided by the analysis made by the Appellate Body in *Canada – Periodicals*.²⁰⁴ In that case, the Appellate Body concluded that the "design and the structure" of the measure was to afford protection to domestic production on the basis of the following factors:

- (i) the magnitude of the tax differential;
- (ii) several statements by the Canadian authorities recognising that the protection of domestic production was one of the measures' policy objectives; and
- (iii) the demonstrated actual protective effect of the measures.

4.392 The European Communities points out that similarly, in *Korea – Taxes on Alcoholic Beverages*²⁰⁵, the panel based its finding that the measures afforded protection to domestic production on the following elements:

- (i) the magnitude of the tax differentials;
- (ii) the structure of Korea's Liquor Tax Law, and more specifically the lack of rationality of the product categorisation; and
- (iii) the fact that there was virtually no imported soju, so that the beneficiaries of the measure were almost exclusively domestic producers.

progressive tax payable on cars of less than the said power rating for tax purposes, where the only cars subject to the special tax are imported, in particular from other member States".

²⁰³ Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II*, *supra.*, p. 29.

²⁰⁴ Appellate Body Report on *Canada - Periodicals*, *supra.*, pp. 30-32.

²⁰⁵ Panel Report on *Korea - Taxes on Alcoholic Beverages*, *supra.*, paras 10.101-10.102.

4.393 **Chile first responds** that given that the taxation is not dissimilar, it is not surprising that the European Communities likewise fails to demonstrate the third element of a violation of Article III -- that the dissimilar taxation operates so as to afford protection to domestic production. In fact, since the European Communities needs to demonstrate all three elements of a violation of Article III:2, second sentence, the Panel could forego a decision on the first and third elements in the interest of judicial economy. Considerations of judicial economy may be especially pertinent here, since a system that does not discriminate based on nationality and uses neutral, objective standards cannot be considered protectionist in any event.

4.394 Chile also replies that there is no precedent for holding inconsistent with GATT 1994 a system of taxation that does not discriminate based on nationality and that employs strictly objective criteria for any differentiation in taxes. Indeed, the same panels that condemned the Japanese system -- and even the European Communities itself in arguing those cases, observed that distinctions based on objective and neutral criteria are permissible under Article III:2.

4.395 Chile further states that Article III does not prohibit a tax or regulation simply because, as a result of the application of objective criteria, some or even many imported products are by some measures treated worse than some or many like or competing domestic products. The drafting history of Article III makes this clear. In the latter stages of the drafting of what became Article III of the GATT, the negotiating Sub-Committee responsible for this Article reported that:

The Sub-Committee was in agreement that under the provisions of Article 18 [Article III of the GATT], regulations and taxes would be permitted which, while perhaps having the effect of assisting the production of a particular domestic product (say, butter) are directed as much against the domestic production of another product (say, domestic oleomargarine) of which there was a substantial domestic production as they are against imports (say, imported oleomargarine).²⁰⁶

4.396 In the view of Chile, the logic of this unanimous understanding of the negotiators is compelling. All WTO Members make tax and regulatory distinctions that fall unevenly by some measures among products that might be considered like or directly competitive or substitutable in the sense of Article III. Sometimes these distinctions will mean that many domestic products will, by some measures, be taxed or regulated more favorably than many like or competing imports. But that is not a violation of Article III, where criteria for the distinctions are objective and neutral.

4.397 Chile also argues that past panels have repeatedly acknowledged these considerations, noting also that Article III is not intended to be used as a tool for harmonizing the tax systems of the WTO Members,²⁰⁷ and that WTO Members retain almost complete freedom with respect to domestic policies that do not distinguish between the origin or destination of goods.²⁰⁸ In *United States - Malt Beverages*, the panel noted that:

The purpose of Article III is not to harmonize the internal taxes and regulations of contracting parties, which differ from country to country.²⁰⁹

4.398 Chile further argues that in *Japan - Taxes on Alcoholic Beverages I*, the panel affirmed this principle with respect to Article III:2, noting that this Article "prohibits only discriminatory or protective taxation of imported products but not the use of differentiated taxation methods as

²⁰⁶ Reports of the Committees and Principal Sub-Committees, *supra*.

²⁰⁷ See Panel Report on *Japan - Taxes on Alcoholic Beverages I*, *supra*.

²⁰⁸ Panel Report on *United States - Malt Beverages*, *supra*, para. 5.25 and Panel Report on *United States - Taxes on Automobiles*, *supra*, para. 3.108.

²⁰⁹ Panel Report on *United States - Malt Beverages*, *supra*, para. 5.71.

such ..."²¹⁰ The panel went on to say "that Article III:2 does not prescribe the use of any specific method or system of taxation ..."²¹¹ This position was also endorsed by the Appellate Body in *Japan - Taxes on Alcoholic Beverages II*.²¹²

4.399 Chile notes that the EC argument against the Chilean system ignores these precepts of Article III, and instead asks the Panel to strike down an objective and neutral tax system merely because a result of the application of that system is that those EC beverages of high alcohol content (and high price) will face higher taxes than those Chilean beverages (primarily certain kinds of pisco) that are of relatively low alcohol strength (and low price). In making this argument with respect to the New Chilean System, the European Communities ignores that many European products, including those most similar to pisco, will benefit from the same lower rates of tax, while other European products could be adapted for the Chilean market merely by diluting with water the current relatively high strength of the products -- as the European Communities has suggested could be done by pisco producers. Equally, the European Communities ignores that under the New Chilean System many Chilean distilled spirits, including Chilean whisky, brandy and gin and very substantial quantities of pisco that are marketed at relatively high prices and alcohol strength, will face the highest rate of taxation.

4.400 Chile concludes that the New Chilean System thus presents precisely the kind of regulatory system that Article III is not intended to condemn:

- (i) there is no distinction in taxation based on origin or on type;
- (ii) many imports can benefit from the lowest tax and all others could be easily diluted for that purpose;
- (iii) many domestic products of Chile will face the highest tax rates under the New Chilean System; and
- (iv) the objective standards mean that foreign producers can readily adapt their products to lower their taxes by a simple process.

4.401 Chile adds that the Appellate Body has properly noted that "Article III protects expectations not of any particular trade volume but rather of the equal competitive relationship between imported and domestic products".²¹³ Foreign and domestic producers have an equality of competitive opportunities, as they have an equal opportunity to adapt their production, if they so choose, in the way implicitly preferred under the New Chilean System, i.e., by reducing alcohol content.

2. Transitional System

4.402 **The European Communities argues** that the following facts and circumstances regarding the "design, structure and architecture" of the transitional system, as well as its "overall application on domestic as compared to imported products" constitute evidence that it is applied "so as to afford protection" to Chile's domestic production:

- (i) the very magnitude of the tax differentials;
- (ii) the absence of any legitimate policy purpose for applying a lower tax rate to pisco;

²¹⁰ Panel Report on *Japan - Taxes on Alcoholic Beverages I*, *supra.*, para. 5.9 b).

²¹¹ *Ibid.*, para. 5.9 c).

²¹² See Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II*, *supra.*, p. 26.

²¹³ *Ibid.*, p.16 (citations omitted).

- (iii) the fact that pisco is, by law, a domestic product;
- (iv) the fact that pisco accounts for the vast majority of the Chilean production of distilled spirits;
- (v) the fact that almost all whisky, as well as a significant proportion of the main liquors falling within the category of "other spirits" are imported; and
- (vi) the admission by the Chilean authorities that the adoption of Law 19,534 was necessary because the system in place was "discriminatory".

4.403 In the view of the European Communities, in *Japan - Taxes on Alcoholic Beverages II*, the Appellate Body observed that the very magnitude of the difference in taxation between Japanese shochu and other distilled spirits was sufficient evidence to conclude that the Japanese Liquor Tax Law was applied so as to afford protection to the domestic production of shochu.²¹⁴

4.404 The European Communities then argues that the same is true in the present dispute. The tax differential between pisco and whisky is so large that it can only be explained by the purpose to afford protection to pisco.

4.405 The European Communities also points out that in *Japan - Taxes on Alcoholic Beverages II*, the taxes in dispute were specific taxes per litre of beverage instead of *ad valorem* taxes. This makes it extremely difficult to compare the tax differentials at issue in the two cases. Nevertheless, it is worth noting that, according to the complainants, in *Japan - Taxes on Alcoholic Beverages II* the differences in specific taxes translated into a difference in tax/price ratios between shochu and whisky of between 10 % and 32 % of their retail sales price.²¹⁵

4.406 The European Communities further notes that according to the explanations provided by Chile during the consultations, the tax differentials between pisco, on the one hand, and whisky and "other spirits", on the other hand, purport to serve two different objectives:

- (i) Protection of public health: it was sought to create a disincentive for the consumption of spirits with a higher alcohol degree, in order to reduce the negative social impact associated with excessive alcohol consumption;
- (ii) Fiscal policy: those liquors, which are subject to higher taxes, are those with the characteristic of luxury goods. The higher tax applied to those goods fulfils the objective that indirect taxes apply in a differentiated manner to luxury goods as a mechanism of income redistribution. Those taxes, known as "luxury taxes", are applied also to other products, both in Chile and in other countries.

4.407 The European Communities then maintains that it is obvious, however, that the application of a much lower rate to pisco than to whisky and "other spirits" cannot be justified by either of those two alleged objectives.

4.408 The European Communities further explains that in the first place, pisco does not always have a lower alcohol content than whisky or "other spirits". Approximately 10 % of the sales of pisco have 40° or more. Moreover, the remaining 90 % of pisco has between 30° and 35°, i.e., only 5 to 10 degrees less than most imported spirits. It is manifestly disproportionate to attach to such a small difference in strength a tax differential of as much as 28 to 45 percentage points *ad valorem*. Finally,

²¹⁴ Ibid., p. 29.

²¹⁵ See Panel Report on *Japan - Taxes on Alcoholic Beverages II*, *supra.*, para. 4.159.

the category of "other spirits" includes many liquors (*e.g.*, most liqueurs) that have a lower alcohol content than pisco.

4.409 The European Communities then argues that the Chile claim that the application of a lower rate to pisco is justified for reasons of income distribution is also spurious. Pisco is not inherently less expensive than other spirits. Moreover, there is evidence that pisco is consumed by all social groups and not just by the less affluent.²¹⁶ Similarly, whisky and the other liquors are widely consumed across social boundaries.²¹⁷ In any event, previous panels have established that this type of consideration cannot provide a valid justification for taxing dissimilarly two directly competitive or substitutable products.

4.410 In support of this argument, the European Communities points out that in *Japan – Taxes on Alcoholic Beverages I*, Japan claimed that the tax differentials at issue in that case were not contrary to Article III:2 because they were based on "... the tax-bearing ability on the part of consumers of each category of liquor". The panel rejected this defence in the following terms:

The Panel was of the view that the use of product and tax differentiations with the view of maintaining or promoting certain production and consumption patterns could easily distort price-competition among like or directly competitive products by creating price differences and price-related consumer preferences which would not exist in case of non-discriminatory internal taxation consistent with Article III:2. The Panel noted that the General Agreement did not make provision for such a far-reaching exception to Article III:2 and that the concept of "taxation according to tax bearing ability of prospective consumers" of a product did not offer an objective criterion because it relied on necessarily subjective assumptions about future competition and inevitably uncertain consumer responses ...²¹⁸

4.411 The European Communities further notes that, in *Japan – Taxes on Alcoholic Beverages II*, the Appellate Body noted that Japanese shochu was insulated from imports of shochu originating in Korea and other third countries by tariff barriers. As a result, by applying a lower tax rate to shochu, Japan favoured exclusively domestic production.²¹⁹

4.412 The European Communities then argues that Chilean pisco is even more effectively isolated from imports of like products. "Pisco" is a geographical denomination reserved by law to certain spirits produced in certain regions of Chile. Thus, the tax advantage provided to pisco benefits exclusively domestic products, not merely *de facto* (as in *Japan – Taxes on Alcoholic Beverages II*) but also *de jure*.

4.413 The European Communities goes on to claim that it may be estimated that pisco accounts for approximately 80 % of the Chilean production of distilled spirits, as shown in Tables 18 and 19 above. For comparison, in *Japan – Taxes on Alcoholic Beverages II*, sales of shochu represented, according to the complainants, "almost 80 %" of Japan's total production of distilled spirits.²²⁰ Therefore, by applying a lower tax rate to pisco, Chile affords protection not just to its domestic production of pisco but more generally to the majority of its domestic industry of distilled spirits.

²¹⁶ The European Communities refers to the 1997 SM survey, p. iv (EC Exhibit 21).

²¹⁷ Ibid.

²¹⁸ Panel Report on *Japan - Taxes on Alcoholic Beverages I*, *supra.*, para. 5.13.

²¹⁹ Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II*, *supra.*, p. 31.

²²⁰ Panel Report on *Japan - Taxes on Alcoholic Beverages II*, *supra.*, para. 4.95.

4.414 In the view of the European Communities, whereas pisco is an exclusively domestic product, approximately 95 % of whisky, the main spirit after pisco, as well as a substantial proportion of the liquors falling within the category of "other spirits" are imported.²²¹

4.415 The European Communities further notes that as stated by the Appellate Body in *Japan – Taxes on Alcoholic Beverages II*²²² in order to establish that a tax measure is applied "so as to afford protection to domestic production", it is not necessary to show that the legislators had the subjective intent of affording such protection. On the other hand, it is evident that where the existence of that intent can be clearly established, it may constitute additional evidence that the measures in dispute are applied in a protective manner.

4.416 The European Communities adds that in *Canada - Periodicals*, the Appellate Body relied upon some statements by the Canadian Government regarding the policy objectives of a measure as one of the factors supporting the finding that the measures at issue were applied "so as to afford protection to domestic production".²²³

4.417 The European Communities then claims that the Chilean Government (through its Minister of Foreign Affairs) as well as many legislators of all political parties recognised openly that the tax system in place until November 1997 had to be amended because it was "discriminatory" and favoured the pisco producers. The transitional regime provided in Law 19,534 will prolong that system into the year 2000. Consequently, the admission by the Chilean authorities that the system in force until November 1997 afforded protection to the pisco producers, also involves an admission that the Transitional System will continue to do so.

4.418 **Chile responds** that the purpose of the Transitional System was to allow time for domestic and foreign producers and distributors to prepare for the changes under the New Chilean System, and also to begin phasing in immediate benefits for whisky producers.

4.419 Furthermore, in Chile's view, pisco and the imported products are not directly competitive or substitutable and, therefore, the Panel need not reach this issue with respect to the Transitional System. Chile also indicates that the Transitional System is an issue of little practical consequence, as it will expire soon.

3. New Chilean System

4.420 **The European Communities claims** that the following factors and circumstances constitute evidence that the New Chilean System will also be applied "so as to afford protection" to Chile's domestic production:

- (i) the magnitude of the tax differentials;
- (ii) the tax distinctions do not serve any legitimate policy purpose;
- (iii) the majority of Chile's domestic production of distilled spirits is taxed at the lowest tax rate;
- (iv) nearly all imports are taxed at the highest tax rate;

²²¹ Ibid.

²²² Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II*, *supra.*, p. 27.

²²³ Appellate Body Report on *Canada - Periodicals*, *supra.*, pp. 30-31.

- (v) the New Chilean System reflects the terms previously agreed by the Chilean authorities with the pisco industry; and
- (vi) the positions taken by the pisco industry during the amendment process of the ILA involve a recognition that maintaining a tax differential between low strength pisco and whisky will afford protection to the pisco industry as a whole.

4.421 **Chile replies** that it is readily apparent, if the Panel chooses to consider this element, that the New Chilean System does not operate "so as to afford protection to domestic production". The European Communities offers up six reasons that the New Chilean System should be considered "to afford domestic protection". None of the six contentions have merit when applied to the New Chilean System.

4.422 In the view of Chile, it is also essential to note in this regard that, unlike systems based on distinctions between different types of distilled spirits, it is a relatively simple matter for foreign and domestic producers to adapt to the neutral and objective standards of the Chilean system. A whisky producer cannot readily become a pisco producer, but a producer of any spirit of 40° alcohol can readily dilute the product to 35°. The European Communities already produces many products (grappa, fruit liqueurs, etc.) that qualify for the lowest taxes and even more products that would qualify if only, as the European Communities suggests be done for pisco, some water is added to the current high alcohol products before bottling. Article III simply does not obligate sovereign Member governments to harmonize their neutral taxation system to the convenience of foreign producers in the way sought by the European Communities in this case. The New Chilean System affects domestic producers of spirits in the same manner as it affects importers of alcoholic beverages, and does not prevent foreign producers of spirits from importing any low alcohol content spirits benefiting from a lower level of taxation on the basis of their alcohol content.

4.423 Chile further states that the European Communities devotes many pages listing excerpts from Chile's legislative debate about the new taxation system. Some of these examples show that legislative representatives of the regions that produce pisco in Chile were seeking to minimize the adverse effects of a New Chilean System on pisco producers and, because adverse effects could not be avoided, also sought other governmental help for their constituents. At least in the case of the legislative history, the European Communities, while presenting a distorted picture, did note many remarks from legislators who announced that the new system was eliminating discrimination against foreign products. Chile submits that if such developments infringe Article III or are even evidence of such infringement, then all WTO Members are in deep peril, not least the European Communities.

4.424 Chile points out that the Appellate Body has already cautioned against this kind of subjective effort to discern motivation. In *Japan - Taxes on Alcoholic Beverages II*, the Appellate Body stated that the issue of "affording protection to domestic production" is an objective question of *effect*, not a subjective question of the intent of legislators.²²⁴

(a) Magnitude of Tax Differentials

4.425 **The European Communities points out** that in *Japan - Taxes on Alcoholic Beverages II*, the Appellate Body observed that the very magnitude of the difference in taxation between Japanese shochu and other distilled spirits was sufficient evidence to conclude that the Japanese Liquor Tax Law was applied so as to afford protection to the domestic production of shochu.²²⁵

²²⁴ Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II*, *supra.*, pp. 27-28.

²²⁵ *Ibid.*

4.426 The European Communities then maintains that under the new system the tax differentials will still be large enough to be, in and of themselves, evidence of protective application. Indeed, in the case of spirits of 40° or more other than whisky the tax differentials will be even larger than under the preceding system.

4.427 **In response, Chile first contests** the citation by European Communities of "the magnitude of the tax differentials of the New Chilean System". The EC's analysis of this point fails for the same reason that the EC's allegations of dissimilar taxation fail. The EC's argument makes no more sense than a claim that *ad valorem* taxes are illegal in any country where imports are generally more expensive than the domestic products with which they compete. The differential in the New Chilean System is nil because all products face the same tax scale and all products have the same opportunity to be adapted in a way that will minimize their tax burden.

4.428 Chile argues that perhaps the European Communities may see the fallacy of its logic more clearly if that logic is applied to the systems of taxation of alcoholic beverages that are used by EC Member States. Chile has already shown, in Tables 28 and 29 above, how the use of specific rate taxes per degree of alcohol (which is the tax system used by a number of EC Member States) discriminates against low price beverages and in favor of higher priced beverages, which are more commonly produced in the European Communities. These points are elaborated further in Tables 34 and 35 below. Applying the same logic that the European Communities seeks to apply to the New Chilean System, the EC Member States would be guilty of violating Article III:2, second sentence. In the European Communities, the result of the use of specific taxes is that pisco is taxed relatively heavily compared to expensive cognac. According to the European Communities, cognac and pisco are directly competitive and substitutable. Cognac is thereby protected from imported pisco (evidenced by the low import penetration in the European Communities of pisco and other imported brandies).

4.429 Chile further maintains that even ignoring for the moment the discrimination in *ad valorem* terms that arises from a specific rate tax, the EC Member States would still be in violation of Article III:2 if the EC's analysis in this dispute were applied to the Member States who impose taxes per degree of alcohol content. The tax per degree of alcohol results in a substantially higher tax on two beverages of the same price, for example, one having 46° alcohol, the other 35°. Therefore, in both absolute and *ad valorem* terms, an imported Gran Pisco would face a substantially higher tax than a low-alcohol European product such as Campari. By the theory that the European Communities seeks to apply to Chile, this means that the EC Member States' systems have the result of discriminating by type, and a type of imported spirit (Gran Pisco) is taxed significantly more heavily than the directly competitive or substitutable domestic product, Campari.

4.430 According to Chile, by the application of the EC's logic, the differences in tax on different types of competing spirits that result from Member State tax systems similarly would easily be found to operate "so as to afford protection to domestic production". The difference in tax alone might be enough to establish the protective effect of the EC Member States' taxation systems. In addition, one might note the obvious "architectural" features favoring low alcohol beverages such as those commonly produced in the European Communities, which means only certain types of distilled spirits are favoured in these countries. To complete the analogy to the logic that the European Communities seeks to apply to Chile, one might also seek evidence that some politician from the area where the low-taxed product is made had boasted of his or her success in helping the domestic industry. Thus guilt under Article III:2 would be complete, by the standard of analysis that the European Communities wishes to apply to Chile in this dispute.

4.431 Chile notes that the European Communities will perhaps protest that the EC system is nevertheless GATT-legal because it is necessary, in terms of Article XX of GATT 1994, to protect human health from the effects of alcohol. That explanation, however, is difficult to sustain in the face

of other EC alcoholic beverage laws that prescribe *minimum* alcohol content, and that tax the alcohol content of wine and beer much less than distilled spirits. As the European Communities points out in the literature appended to its responses to the Panel's questions, some EC authorities believe that health problems are connected to the issue of amount of alcohol consumed, not the concentration in different beverages.

4.432 Chile further notes that in pointing out the above, it is not asking the Panel to find the EC Member States guilty, an issue that is not even before this Panel. Chile is seeking to demonstrate, however, the fallacy and dangers of the EC analysis, which seems to have been drawn more from the Scotch Whisky Association's crusade to equalize alcohol taxes in the EC Member States than from a correct analysis of Article III:2.

4.433 Chile then extends its analysis to demonstrate that the alleged protection that the Chilean taxation system provides to pisco is far less significant than the protection offered to whisky by the taxation system applicable in various EC Member States, as can be observed in the following table.²²⁶ In effect, the Chilean taxation system offers a 16% protection to spirits of 35° or less (including pisco 35°) *vis-à-vis* spirits of 39° or more (including whisky), regardless of national origin. Protection for pisco of 40° or more is nil. In contrast, the taxation system of several Member States of the European Communities results in between 23% and 44% protection for whisky *vis-à-vis* pisco 35°; and between 13% and 26% protection for whisky *vis-à-vis* pisco 40°. This is due, as Chile has pointed out in several instances, to the fact that pisco costs much less than whisky, and thus is affected proportionally much more than whisky by a specific tax.

²²⁶ Chile explains that the methodology that was used for the calculation of the Protection of the Special Tax of Whisky (in the selected country members of the European Communities) is:

$$\text{Protection} = \frac{\text{RPDI}}{\text{RPAI}}$$

where:

RPDI: is the Price ratio after Tax.

RPAI: is the Price ratio before Tax.

In this methodology, the calculation comprises both the protection of custom duties and taxes.

In the case of the protection of Pisco in Chile, the methodology used is:

$$\text{Protection} = \frac{\text{RPDI} - 1}{\text{RPAI}}$$

Table 34²²⁷

DEGREE OF PROTECTION OF WHISKY IN COMPARISON TO
 PISCO IN SOME COUNTRY MEMBERS OF THE EUROPEAN
 COMMUNITIES

	Price (US\$/lt)			Price ratio		Protection Special Tax	
	Pisco 35°	Pisco 40°	Whisky 43°	Whisky/ Pisco 35°	Whisky/ Pisco 40°	Whisky/ Pisco 35°	Whisky/ Pisco 40°
CIF/ex-factory	2.60	3.60	5.70	2.19	1.58		
Price after duty							
Spain	2.86	3.89	5.70	1.99	1.47		
United Kingdom	2.86	3.89	5.70	1.99	1.47		
France	2.86	3.89	5.70	1.99	1.47		
Germany	2.86	3.89	5.70	1.99	1.47		
Price after duties and special tax							
Spain	5.51	6.93	8.96	1.63	1.29	23%	13%
United Kingdom	14.23	16.89	19.67	1.38	1.16	44%	26%
France	9.20	10.94	13.17	1.43	1.20	39%	22%
Germany	8.46	10.29	12.58	1.49	1.22	34%	20%

²²⁷ Chile Rebuttal Submission, Annex B, p.13.

Table 35²²⁸

DEGREE OF PROTECTION OF PISCO WITH REGARD TO
 WHISKY IN CHILE

	Price (US\$/lt)			Price ratio		Protection Special Tax	
	Pisco 35°	Pisco 40°	Whisky 43°	Whisky/ Pisco 35°	Whisky/ Pisco 40°	Whisky/ Pisco 35°	Whisky/ Pisco 40°
CIF/ex-factory	2.30	3.30	6.00	2.61	1.82		
Price after duties							
Chile	2.30	3.30	6.66	2.90	2.02		
Price after duties and special tax							
Chile	2.92	4.85	9.79	3.35	2.02	16%	0%

4.434 **The European Communities notes** that Chile raised the argument that the EC system of taxation of spirits affords protection to the EC domestic production because, on an *ad valorem* basis, pisco is taxed more than the EC spirits. Chile explained that its intention in making this argument was not to question the compatibility of the EC system with Article III:2, but rather to illustrate the point that "neutral" tax distinctions may nevertheless have an incidental protective effect.

4.435 The European Communities goes on to state that Chile's argument is not only irrelevant for this dispute, but also wrong, both as a matter of law and of fact. First and foremost, the EC system is based on the application of a uniform specific tax per hectolitre of pure alcohol to all the products containing ethyl alcohol.²²⁹ Thus, unlike in the Chilean system, in the EC system all ethyl alcohol is equally taxed, irrespective of the product in which it is contained. Therefore, the question whether protection is afforded to domestic production through "dissimilar" taxation does not even arise.

4.436 The European Communities maintains that in any event, the EC system does not have the effect alleged by Chile. EC produced spirits are often less expensive than imported spirits. This can be easily demonstrated with the help of Chile's own price data. Table 15 above shows that Canadian whisky, US whisky and Mexican tequila are more expensive (and, therefore, less taxed in *ad valorem* terms under the EC system) than a relatively expensive brand of Scotch whisky such as Johnnie Walker Red Label.

²²⁸ Chile Rebuttal Submission, Annex B, p. 14.

²²⁹ Council Directive 92/83/EEC, of 19 October 1992 (OJ No L 316 of 31.10.92) and Council Directive 92/84/EEC, of 19 October 1992 (OJ No L 316 of 31.10.92).

4.437 The European Communities further argues that when sold in the EC market, Chilean pisco may be as expensive as good quality EC spirits. Tables 34 and 35 above compare the producer's ex-factory price of pisco in Chile with the retail prices of some EC spirits (including insurance, freight and distribution expenses) charged by a duty-free supplier (presumably, also in Chile). Given the differences in level of trade, it would have been surprising if Chilean pisco was not less expensive than the EC spirits. The table below compares the actual retail prices in a supermarket in Brussels of *pisco especial* Capel of 35° (a relatively inexpensive brand in Chile) and a sample of well-known (and relatively up-market) brands of EC produced spirits. It shows that, contrary to Chile's claims, pisco is taxed in *ad valorem* terms at a similar rate as the EC spirits.

Brand (all bottles are 70 cl)	Price (BEF)	Tax (BEF)	Equivalent <i>Ad valorem rate</i>
Pisco Capel 35°	410	155.6	37.95 %
Vodka Smirnoff	415	166.7	40.17 %
Gin Gordon's	409	166.7	40.76 %
Brandy Veterano	477	160	33.54 %
J. Walker Red Label	494	177.8	35.99 %

Source: Retail prices at the supermarket Delhaize Chazal, Brussels, on 28/10/98. See EC Exhibit 64.

4.438 With regard to the effect of specific taxes, **Chile maintains** that Tables 34 and 35 above are accurate. In those tables, the calculations indicated in the first 3 columns (labelled pisco 35°, pisco 40° and whisky 43°) are based on *after customs* price for pisco in Europe, and producers prices for whisky.²³⁰ From those tables it can easily be seen that a specific tax levied on alcohol content produces a dissimilar taxation, if the comparison is made on an *ad valorem* base. Chile asks the Panel to note that this dissimilarity is much larger than the dissimilarity generated by the Chilean system alleged by the European Communities. For clarity purposes, Table 35 above is summarized below:

²³⁰ Chile adds that after customs price of Pisco was estimated considering producers price in Chile, transportation to Europe and related insurance costs and customs duties in Europe. Producers price of whisky, was estimated in US\$ 5.70.

SPECIFIC TAX ON ALCOHOLIC BEVERAGES IN SOME EC MEMBER STATES			
MEASURED IN <i>AD VALOREM</i> TERMS (%)			
Member State	Pisco 35°	Pisco 40°	Whisky 43°
Estimated Price	US\$ 2.90	US\$ 3.90	US\$ 5.70
Spain	92.9	78.1	57.3
Great Britain	397.9	334.2	245.1
France	221.9	181.2	131.0
Germany	195.9	164.6	120.7

(b) Legislative Objective

4.439 **The European Communities maintains** that the tax distinctions in dispute do not serve any legitimate purpose. They are simply a subterfuge to replicate the protective effects of the preceding system. Alcohol content has been chosen as a taxation criterion merely because it allows Chile to distinguish indirectly between the majority of pisco, on the one hand, and the majority of imported spirits, on the other hand, and not because the ILA purports to discourage the consumption of alcohol.

4.440 In support, the European Communities goes on to state that the New Chilean System is a rather unusual method of taxing alcoholic beverages. In fact, that method does not correspond to any of the three methods commonly applied by most countries, and which are: a) *specific* taxes based on the alcohol content (e.g., x pesos per litre of pure alcohol or per degree of alcohol); b) *specific* taxes based on the volume of beverage (e.g., x pesos per litre of pisco); and c) *ad valorem* taxes on the price of the beverage.

4.441 According to the European Communities, instead, the method devised by Chile is a hybrid one in which *ad valorem* rates vary according to alcohol content. The rationality of that method in terms of fiscal policy is questionable. The price of distilled spirits is not correlated to their alcohol content. Indeed, if there was such a direct correlation, high strength ethyl alcohol would be more expensive than any other distilled spirit. The absence of a direct correlation between price and alcohol content means that the goal of *ad valorem* taxation (imposing a higher burden on the more valuable products) and the goal of taxing alcohol content (discouraging the consumption of alcohol) may conflict and ultimately cancel each other.

4.442 The European Communities also argues that the absence of any legitimate policy purpose is further evidenced by the lack of internal coherence of the ILA, and in particular by the following aspects of its "design, structure and architecture".

4.443 First, the European Communities points out that all liquors of 35° or less are taxed at the same *ad valorem* rate. As a result, low strength liquors (e.g., light liqueurs) are taxed more heavily per degree of alcohol than pisco of 35°. Thus, contrary to Chile's claims, the ILA actually encourages the consumption of alcohol, rather than discourages it.

4.444 Second, the European Communities notes that there is no objective reason that can explain why the *ad valorem* rate starts to increase from precisely 35°. The only reason for choosing that strength level as the starting point is simply that 35° is the most usual alcohol content of *pisco especial*, which together with *pisco corriente* of less than 35° accounts for 90 % of the sales of pisco.

4.445 The European Communities explains that if the rate had started to increase from 0° instead of 35°, the applicable rate on pisco of 35° would have been much higher (140 %) unless, of course, the rate increased by smaller increments than the current 4 percentage points per degree of alcohol. But if Chile had applied a smaller increment per degree of alcohol, the applicable *ad valorem* rate on spirits of 40° would have also been lower, a result unacceptable to Chile's pisco industry.

4.446 Third, the European Communities notes that between 35° and 40°, the tax rate increases very rapidly, by no less than 4 percentage points for each additional degree of alcohol. As a result, a difference of merely 5 degrees of alcohol content leads to the application of a tax on spirits of 40° which is 74 % higher than the tax on spirits of 35°. Such a tax differential is disproportionate to the additional damage to human health or other undesirable social effects (if any at all) which may result from drinking spirits of 40° instead of spirits of 35°. The magnitude of that tax differential is even more arbitrary in view of the fact that similar differences in alcohol content outside the 35°- 40° bracket do not entail any difference in taxation at all. For instance, *pisco corriente* is typically bottled at 30°, five degrees less than *pisco especial*. Yet, both *pisco especial* and *pisco corriente* are taxed at the same rate.

4.447 Fourth, the European Communities states that all spirits above 39° are taxed at the same rate. Again, this has the paradoxical result that the alcohol contained in very high strength liquors such as *gran pisco* of 46° or even 50° is taxed less than the alcohol contained in spirits of 40°.

4.448 The European Communities adds that in the 1995 Proposal, the rate continued to increase until 42°. As shown in Table 5, all the main types of imported spirits can be legally sold in Chile (and are usually bottled in their countries of origin) at 40°. Thus, in practice the imposition of higher tax rates above 40° would have had little impact on imports. For instance, the exporters of whisky would have reacted to the imposition of a much higher tax on whisky of 43° than on whisky of 40° simply by replacing current exports of whisky of 43° by shipments of whisky of 40°. This development was anticipated by the pisco industry, which explains its quiet acquiescence to what in practice was but a purely "cosmetic" amendment of the 1995 Proposal. Thus, according to press reports, when presenting the 1996 Gemines study, Mr Peñafiel (general manager of Capel) noted that:

[A]lthough nowadays, the largest part of [whisky] imported [into Chile] has 43°, so that the tax will decrease only to 65 %, in the future the product will arrive at 40°, something which, [Mr Peñafiel] underlined, is already a characteristic of all whisky sold in Europe.²³¹

4.449 **In rebuttal, Chile points out** that it has explained to the European Communities that the Chilean tax system serves legitimate revenue, health and social purposes, primarily by taxing more heavily products that are more costly and higher in alcohol content. It is not for the European Communities to second guess those purposes. While there are trade-offs in fulfilling these objectives, the relevant point is that the system is indeed neutral and objective. One might indeed question the motivation and effectiveness of countless internal measures of the European Communities or any other WTO Member, but Article III was not established so that the WTO could sit in judgement on the "legitimacy" of the policy objectives of its Members, so long as the measures themselves objectively conform with the WTO Agreement.

²³¹ *El Diario*, 2 July 1996, (EC Exhibit 30).

4.450 Chile alleges that in amending its laws, it had had in mind several objectives, including:

- (i) maintaining fiscal revenue;
- (ii) eliminating type distinctions such as those that had existed in Japan (which also would eliminate the alleged discrimination against whisky in the previous system);
- (iii) discouraging alcohol consumption; and
- (iv) minimizing the potential regressive aspects of reforming the tax system.

4.451 Chile points out that because the New Chilean System will change the rate of tax paid with respect to various products, there is the Transition System, under which the whisky tax is phased down immediately, but the remainder of the system takes full effect on 1 December 2000. In the intervening time, whisky producers will enjoy continuing tax reductions, while other producers can decide how they wish to approach the Chilean market under the New Chilean System.

4.452 Chile argues that the new Chilean law completely reforms Chilean taxation of alcoholic beverages and advances the objectives noted above, while conforming to Article III.

4.453 Chile goes on to explain that in November 1997 it enacted new legislation substantially reforming the Chilean system of taxation of distilled spirits. Within this new system, spirits of 35° or less will be taxed at 27% *ad valorem*. The *ad valorem* tax will rise 4 percentage points for each additional degree of alcohol content above 35°, but with the rate capped at 47% for spirits above 39° of alcohol content. Therefore, lower alcohol content products have a lower tax rate, while those having a higher alcohol content have a higher tax rate. The new Chilean system will make no tax distinction by type of distilled beverage or origin. (i.e., domestic or imported). The same *ad valorem* tax rate is applied to all distilled spirits having the same alcohol content.

4.454 Chile further argues that, concerning tax differentials, there is no difference in that all distilled spirits of the same alcohol strength are subject to an identical *ad valorem* tax. The European system is the same, in that all distilled spirits of the same alcohol strength face the same rate of tax, except that the EC tax is a specific one, which, of course, falls more heavily on lower priced products than on higher priced products. Both tax systems use identical scales for all distilled spirits (except beer and wine, which are taxed less in the European Communities and more in Chile), but the EC's system is more distortive because of the use of specific taxes per degree of alcohol.

4.455 Chile further explains that within this context, the new system is built around objective and non-discriminatory criteria has the effect *inter alia* of reducing the present tax rate applied to some products, as is the case for whisky, and of increasing it for others, as is the case for pisco in all its categories (i.e., pisco of high and low alcohol content).

4.456 According to Chile, the new Chilean System is based on two objective criteria: alcohol content and price (i.e., *ad valorem*) of the product, regardless of its type, origin and labeling. Taxation based on alcohol content and on an *ad valorem* basis is not against Article III of GATT or any other provision of the multilateral trading system and both are widely used.

4.457 Chile notes that the *ad valorem* taxation system does not distort competitive attributes of products (i.e., price relationships), as opposed to those which an absolute value is imposed according to alcohol content. Such specific tax systems introduce a distortion biased in favor of products of higher price since a fixed tax will be a smaller percentage of the value of a high priced product.

4.458 Chile poses a question: why did the European Communities insist on pursuing the WTO challenge against the New Chilean System? Chile considers that is not so hard to understand. The major exporters of distilled spirits want to minimize their tax burdens in all markets, and such exporters would prefer not to have to adapt their products to individual markets. Chilean exporters, similarly would prefer not to have to adapt their products to individual markets.

4.459 Chile goes on to state that, in this sense, it can understand why European exporters of distilled spirits would be willing to take a chance on continuing their old GATT challenge against the Chilean system even after its reform, since failure would leave them no worse off while the possibility of success might reduce their taxes.

4.460 Chile further notes that the European Communities continues its attacks on the motivations for Chile's tax laws. For example, Chile is accused both of hiding its motivations and failing to achieve the objectives in a fashion that the European Communities finds sufficiently coherent. Chile has freely conceded that its objectives required a measure of compromise between different objectives, but not a compromise on GATT compliance.

4.461 Further, Chile claims that it is not revealing a secret that WTO member governments all over the world tax alcoholic beverages at higher rates than most products, partly for revenue reasons that contradict to some extent the health reasons. If that establishes a violation of GATT obligations, then the European Communities will have much policing and self-policing to do in the world and at home.

4.462 Chile indicates that it is not critical of the European Communities for having their system, because a multiplicity of motivations is common for all kinds of taxes in every country. It is not Chile who is attacking objective systems that have differential results. Nevertheless, the European Communities should see that objective tax systems can have uneven results when measured by a subjective categorization system. Chile also cannot help being bemused by the EC's diligent efforts to find a justification for its specific tax on ethyl alcohol. Neither the Chilean nor the EC system appears to qualify under the Article XX exception. At least, Chile believes that the European Communities would have a difficult time explaining the necessity of this tax to discourage consumption of ethyl alcohol in distilled spirits (does wine or beer alcohol not impair the senses?). Chile also wonders what scientific analysis produced the varying scales of taxation, and how the EC's health goals are reconciled with the EC's minimum alcohol requirements for various spirits and with its socialisation objectives for distilled spirits.

4.463 In the view of Chile, like nearly all tax measures in nearly all countries, the New Chilean System serves various objectives, and to some extent is a compromise among these objectives. Chile understands that the issue before this Panel is the conformity of the New Chilean System with Article III:2 rather than the various policy objectives that may have been considered by different legislators and government agencies involved in developing that law. Nevertheless, Chile provided some explanations in order to understand the Chilean legislation.

4.464 Chile explains that in Chile, as in many countries, the Finance Ministry has a significant role in tax policy. In providing its input into the development of the New Chilean System, the Chilean Finance Ministry sought to achieve two broad objectives: tax revenues that would be approximately equivalent to those obtained under the Old Chilean System; and a distribution of the burden of the taxes that would not be more regressive than that of the Old Chilean System, i.e., that would not increase the relative tax burden on the poorer income-earners relative to the wealthier income-earners.

In its support, Chile puts forward Tables 36 and 37.

Table 36²³²

Weighting Factors for Expenditure on Alcoholic Beverages Per Quintile

	Overall	Q1 (<Income)	Q2	Q3	Q4	Q5 (>Income)
Total	100.000	100.000	100.000	100.000	100.000	100.000
Alcoholic Beverages	0.930	0.985	1.124	1.107	1.061	0.781
Wine	0.301	0.362	0.350	0.328	0.318	0.269
Champagne	0.025	0.033	0.017	0.019	0.035	0.023
Chicha	0.010	0.005	0.024	0.020	0.010	0.006
Beer	0.295	0.384	0.488	0.467	0.352	0.172
Pisco	0.172	0.166	0.185	0.194	0.213	0.147
Whisky	0.050	0.000	0.011	0.026	0.050	0.072
Other spirits	0.077	0.035	0.049	0.053	0.083	0.092
Number of households	1,363,706	272,741	272,741	272,741	272,741	272,741
Total expenditure	607,718	38,728	60,757	83,591	123,755	300,888

Percentage Distribution of Expenditure Per Quintile

	Overall	Q1 (<Income)	Q2	Q3	Q4	Q5 (>Income)
Alcoholic beverages	100%	6.7%	12.1%	16.4%	23.2%	41.6%
Wine	100%	7.7%	11.6%	15.0%	21.5%	44.2%
Champagne	100%	8.4%	6.8%	10.5%	28.5%	45.6%
Chicha	100%	3.2%	24.0%	27.5%	20.4%	29.7%
Beer	100%	8.3%	16.5%	21.8%	24.3%	28.9%
Pisco	100%	6.2%	10.8%	15.5%	25.2%	42.3%
Whisky	100%	0.0%	2.2%	7.2%	20.4%	71.3%
Other liqueurs	100%	2.9%	6.4%	9.5%	22.0%	59.2%

Source: Survey of household budgets 1996/1997 (National Institute of Statistics) (to be published).

Q = Quintile.

²³² Chile Response to Questions asked at the First Substantive Meeting, p. 35.

Table 37²³³

Distribution of Revenue by Income Quintile

Additional Tax on Alcoholic Beverages

Millions of Chilean Pesos (\$), May 1997²³⁴

Case 1: Former System vs. Law No. 19,534 (1997)

	Weighting factors for expenditure		Revenue 1996	Revenue under new system	
	Q: I, II, III	Q: IV, V		e=0	e=1
Pisco	32.4%	67.5%	12,012	14,512	13,799
Whisky	9.4%	91.7%	7,090	4,760	5,505
Spirits	18.7%	81.1%	4,844	5,998	5,617
Burden 1996	5,464	18,540	24,004		
Burden under new system e=0	6,273	19,028	25,301		
Burden under new system e= 1	6,040	18,920	24,960		
Change e=0	14.8%	2.6%	5.4%		
Change e=1	10.5%	2.1%	4.0%		

Case 2: Former System vs. Uniform Ad Valorem Rate (34%)

	Weighting factors for expenditure		Revenue 1996	Revenue under new system	
	Q: I, II, III	Q: IV, V		e=0	e=1
Pisco	32.4%	67.5%	12,012	16,337	15,240
Whisky	9.4%	91.7%	7,090	3,444	4,369
Spirits	18.7%	81.1%	4,844	5,490	5,326
Burden 1996	5,464	18,540	24,004		
Burden under new system e=0	6,646	18,642	25,289		
Burden under new system e= 1	6,346	18,616	24,963		
Change e=0	21.6%	0.6%	5.4%		
Change e=1	16.1%	0.4%	4.0%		

Source: Survey of household budgets 1996/1997 (National Institute of Statistics) Ministry of Finance model.

Q = Quintile

4.465 Chile indicates that Table 36 sets forth the weighting factors for expenditure by the different income quintiles of the population on the most commonly consumed alcoholic beverages. By analysing the distribution of expenditure on each type of beverage according to income quintile, it is easy to appreciate that in the case of both whisky and the other non-pisco beverages, it is the higher income groups that account proportionally for the greatest consumption. Whisky, in particular, has always been considered as a luxury good consumed for the most part (92 per cent) by the high income groups. The source of this information is the Survey of Household Budgets 1996/1997 by the National Institute of Statistics.

²³³ Chile Response to Questions asked at the First Substantive Meeting, p. 36.

²³⁴ Chile explains that the measurement can be made under two hypothetical elasticity scenarios: e=0: constant consumption, and e=1: constant expenditure.

4.466 Chile further claims that Table 37 shows the impact of different tax structures on different socio-economic groups. Quintiles I, II and III (lower income), and quintiles IV and V (higher income), have been grouped together. With the revenue obtained from the model described above (Section I) and the distribution of expenditure according to the above table it is possible to estimate the change in the tax burden on the different socio-economic groups, for the products concerned, under the new tax structure and under the flat structure (both having the same effect on aggregate revenue). The results show that the flat structure involves a greater change in the tax burden (16-22 per cent) than under the new structure (11-15 per cent) for the lower income groups. For the higher income groups, the tax burden under the flat rate remains practically unchanged (<1 per cent) in relation to the new structure (2-3 per cent).

4.467 According to Chile, the first of these Finance Ministry objectives -- approximate equality of tax revenues -- could have been achieved through a flat *ad valorem* tax. However, such a tax would have been materially more regressive in its effects than the Old Chilean System in terms of income distribution. In Chile, with the exception of certain specialty liqueurs primarily imported from Europe (such as Campari), there tends to be a correlation between higher prices and higher alcohol strength. Thus, by having the *ad valorem* tax rise with alcohol content, the progressive distribution of tax revenues is enhanced.

4.468 Chile states that two further points should be noted in this regard. First, notwithstanding the objective not to have a more regressive incidence of taxation on the different quintiles of the population, the New Chilean System is slightly more regressive than the Old Chilean System. That is primarily because of the drastic reduction in tax on whisky, which is a relative luxury good in Chile, and the increase in tax on the cheapest grades of pisco, the most common drink for poorer Chileans. (Ironically, in light of Europe's current complaint, the only motivation for this regressive step of reducing the tax on whisky was to respond to the trade complaint of the European Communities).

4.469 Chile further notes that the second point that should be noted is that the Finance Ministry assessment was a static analysis, based on two arbitrary assumptions:

- (i) that there would be no adjustment by consumers in their spending patterns as a result of the changed tax system; and
- (ii) that there would be no adjustment of the alcohol strength of their products by producers to try to take advantage of the lower *ad valorem* rates applied to lower alcohol strength products.

4.470 Chile also notes that as to whether producers will adjust the alcohol strength of their products, that is difficult to tell. Chile would guess that, if the United States adopted the Chilean Tax System tomorrow, within weeks Chile would see distilled spirits producers of the world undertaking the simple dilution that is required to qualify for lower taxes. Thus would be born "Johnny Walker Light," "Beef Eaters Lean," etc., all marketed at lower alcohol strength. The highest quality producers (like producers of *gran pisco*) might not wish to adjust their products, but those wishing to compete on price at the low end of the market might well decide to adapt their products.

4.471 Chile further explains that consumer health is one of the considerations that led to higher taxation of higher alcohol strength beverages in Chile, as Chile assumes is the case in other countries, including the European Communities and the United States. Health is not the only objective however, or Chile would have imposed still higher taxes on beverages over 40° alcohol, a step that would have led to even higher taxation of European whisky.

4.472 Chile then maintains that increasing the *ad valorem* tax rate as alcohol content increases has both health benefits (by discouraging consumption of high alcohol products) and "social" benefits

(because it makes the tax system more progressive). Chile points out these considerations to enhance the Panel's understanding of the Chilean law, but Chile does not claim an Article XX exception, which in any case is unnecessary given the conformity of Chile's law with Article III.

4.473 Chile states that doubtless, different beginning and ending points for the tax might have been chosen, especially if health had been the only motivating factor for the New Chilean System. However, Chile was also seeking to reduce the tax on whisky in response to the trade complaints of the European Communities, to reform the old system based on type of distilled spirits and to maintain both gross tax revenues, and to avoid making the system more regressive in the distribution of the relative tax burden on different income groups in Chile.

4.474 Chile further explains that the system finally enacted addressed all these objectives. Most importantly for purposes of this proceeding, the New Chilean System also conforms with Article III. The New Chilean System does not discriminate between domestic and foreign products. The identical scale of taxation, based entirely on objective criteria is applied to all products, whether or not those products are like, directly competitive, or substitutable.

4.475 **The European Communities contends** that Chile's manifest inability to reconcile the tax distinctions with the stated policy objectives of the New Chilean System provides further confirmation that, in reality, those distinctions are applied with the exclusive purpose to afford protection to its domestic production.

4.476 In the view of the European Communities, in essence, Chile argues that the policy objectives of its New Chilean System are none of the EC's business and should not be examined by this Panel. The European Communities has acknowledged that it is for each Member to choose its own taxation objectives. At the same time, it is obvious that the inadequacy of a tax system to achieve its self-stated objectives is highly probative that the system is in fact being applied so as to afford protection to domestic production. This type of analysis is part of the examination of the "design, the architecture and the revealing structure" of tax measures which panels have been enjoined to conduct by the Appellate Body.²³⁵

4.477 The European Communities explains that its intention in making this argument was simply to demonstrate that the New Chilean System is objectively inapt to serve the taxation goals stated by Chile itself. Additional confirmation of this is provided by the fact that, to the EC's best knowledge, no other country in the world applies the same system, even though many countries pursue similar taxation objectives. The inadequacy of the New Chilean System to achieve Chile's purported policy goals evidences that, in reality, that tax system has been designed with the exclusive purpose to continue to afford protection to Chile's domestic production of spirits. The European Communities does not exclude, however, that there may be other taxation methods which permit Members to attain the policy goals stated by Chile without affording protection to Chile's domestic production.

4.478 The European Communities further claims that it is only in response to a question from the Panel that Chile has eventually acceded to explain in some detail its purported taxation objectives. The response furnished by Chile fully explains its reluctance to let the Panel address this question.

4.479 The European Communities goes on to state that Chile acknowledges that the tax differentials cannot be explained by health protection reasons, because in that case the tax rate should have continued to increase above 40°. To this, it should be added that, if health considerations played a genuine role, alcohol contained in pisco would not be taxed less than alcohol contained in low strength liqueurs. Furthermore, health considerations cannot explain the huge tax differential between spirits of 35° and spirits of 39°.

²³⁵ Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II*, *supra.*, p. 29.

4.480 In the view of the European Communities, Chile also admits that the tax distinctions are not necessary in order to preserve the previous level of tax revenues. That objective could have been achieved as well by applying a flat *ad valorem* rate at an appropriate level on all alcoholic beverages. Or, in case the concern with health protection was real, by applying a flat specific rate on alcohol content, also at an appropriate level.

4.481 According to the European Communities, in view of the above, it must be concluded that the very peculiar features of the New Chilean System are considered necessary by Chile in order to achieve the third policy objective mentioned in its response to the Panel, namely the objective that the new system should not be more "regressive" than the previous one. As shown below, this justification is spurious.

4.482 The European Communities then argues that the only alternative to the New Chilean System which appears to have been considered by Chile's Ministry of Finance is the application of a pure *ad valorem* rate at 34% (hereafter, the "Alternative System"). Chile does not argue that the Alternative System would be "regressive", in the sense that the poor would pay a higher share of their income than the rich. Rather, Chile's contention is that the Alternative System would be less "progressive" than the New Chilean System, because the poor would contribute a larger portion of the tax proceeds. The difference, nevertheless, is very small. According to the estimates of the Ministry of Finance, under the New Chilean System the three lowest income quintiles would pay between 24.2 % and 24.8 % of the total tax revenue. Under the Alternative System, those quintiles would contribute between 25.4 % and 26.2 % of the total tax revenue.²³⁶

4.483 The European Communities further argues that at any rate, Chile's contention that the chosen system is less "progressive" is based on two erroneous assumptions.

4.484 The European Communities first explains that Chile assumes that there is a direct correlation between alcohol content and price. Yet the European Communities has already demonstrated that there is no such correlation. Chile's own data provide further confirmation of this. Contrary to Chile's claims, it is not only certain imported "speciality liqueurs" which are more expensive than high strength spirits. One of the tables given by Chile shows that, for example, pisco of 35° is more expensive than *aguardiente* of 50°, brandy of 38° and rum of 40° and as expensive as gin of 40°.

4.485 The European Communities goes on to state that on Chile's own construction, even if there existed now a correlation between alcohol content and price (*quod non*), such correlation would be broken as a result of the systematic dilution of high strength spirits in order to escape the highest tax rates (unless Chile is arguing that diluted premium Scotch will be sold at the same price as cheap *pisco corriente*). Thus, eventually the New Chilean System would be as "regressive" as a pure *ad valorem* system. Further, if imported high strength spirits were diluted to 35°, the New Chilean System could not, unlike the Alternative System, achieve the objective of maintaining the same level of tax revenues.

4.486 In the view of the European Communities, the second mistaken assumption is that the consumption patterns of the different income groups are not affected by the level of the taxes applied to each type of spirit, and therefore, by their level of prices. In other words, Chile assumes that the tastes of the poor will remain forever different from the tastes of the rich. As admitted by Chile itself, that assumption is "arbitrary".

²³⁶ The European Communities notes that the analysis made by Chile's Ministry of Finance obscures how small is the difference by focusing on the differences in the percentage by which the tax burden on the three lowest income quintiles increases in the New Chilean System and the Alternative System, compared to the old system.

4.487 The European Communities explains that if the Alternative System appears to be more "regressive" than the New Chilean System in the analysis made by the Ministry of Finance, it is simply because the burdens on each income group are calculated on the basis of their spending patterns under the old tax system in force in 1996, when whisky was taxed at 70 % and pisco at 25 %. In view of that tax differential, it is hardly surprising if in 1996 the two top income quintiles accounted for a large portion of the consumption of whisky. If in 1996 the taxes on whisky (and consequently the prices) had been lower, consumption of whisky by the remaining income quintiles would have accounted for a higher percentage.

4.488 The European Communities concludes that, in sum, Chile's attempted justification rests on purely circular reasoning. Whisky is taxed at a higher rate because it is considered to be the drink of the rich. Yet, the reason why it is assumed to be the drink of the rich is because in the past the poor drank less whisky compared to pisco than the rich. But one of the reasons why the poor drank less whisky compared to pisco than the rich was precisely because whisky was taxed much more heavily than pisco.

4.489 The European Communities further argues that the same type of argument now made by Chile was raised by Japan in *Japan – Taxes on Alcoholic Beverages I*. It was rejected by the panel in categorical terms:

The Panel noted the Japanese submission that ... generally "taxes on liquors are levied according to the tax bearing ability on the part of consumers of each category of liquor". The Panel was of the view that the use of product and tax differentiations with the view of maintaining or promoting certain production and consumption patterns could easily distort price competition among like or directly competitive products by creating price differences and price-related differences which would not exist in case of non-discriminatory internal taxation consistent with Article III:2. The Panel noted that the General Agreement does not make provision for such a far-reaching exception to Article III:2 and that the concept of "taxation according to tax-bearing ability of prospective consumers" of a product did not offer an objective criterion because it relied on unnecessarily subjective assumptions about future competition and inevitably uncertain consumer responses.²³⁷

4.490 In conclusion, the European Communities states that, in sum, the New Chilean System that has the clear effect of favouring pisco, the local spirit, over other types of spirits imported from the European Communities and other Members. Furthermore, the "structure", the "design" and the "architecture" of the system cannot be rationally explained except as being pre-ordained to achieve precisely that protective effect. The inescapable conclusion is that the New Chilean System is applied "so as to afford protection to domestic production", contrary to Chile's obligations under GATT Article III:2.

(c) Percentage of Less Taxed Products in Domestic Products

4.491 **The European Communities claims** that as shown in Table 3 above, approximately 90 % of pisco is bottled at 35° or less and is therefore eligible for the lowest applicable tax rate of 27 % *ad valorem*. Furthermore, there is nothing that prevents Chile's pisco manufacturers from replacing their current production of pisco of more than 35° by pisco bottled at a lower strength so as to benefit from the lowest tax rate.

4.492 In the view of the European Communities, the only other spirit types with a significant volume of sales that may qualify for the lowest tax rate are liqueurs and *aguardiente*, virtually all of

²³⁷ Panel Report on *Japan - Taxes on Alcoholic Beverages I*, *supra.*, para. 5.13.

which are domestically produced. It can be estimated that, together, pisco, liqueurs and *aguardiente* of 35° or less may account for as much as 75 % to 85 % of Chile's total production of distilled spirits. Thus, the New Chilean System will continue to favour a large majority of Chile's production of distilled spirits.

4.493 The European Communities argues that finally, Chile has failed to rebut the EC's evidence showing that the New Chilean System is applied "so as to afford protection to domestic production". Under the New Chilean System, more than 95 % of imports will be taxed at the highest tax rate. In contrast, between 75 and 85 % of domestic spirits (including 90 % of pisco) will be taxed at the lowest rate. Moreover, sales of domestic spirits with a minimum alcohol content of more than 35° represent only 6 % of domestic production.²³⁸ Thus, potentially nearly all domestic production qualifies for the lowest tax rate. The mere fact that some domestic products fall within the more taxed category is not sufficient, in light of previous panel reports, to exclude a finding of protective application. What really matters is that the vast majority of Chile's domestic production falls within the most favoured category.

4.494 The European Communities notes that Chile claims that domestic production accounts for 70 % of the spirits subject to the highest tax rate. That figure, however, is deceptive. The supporting tables²³⁹ shows that only 26 % of domestic production consists of spirits with a minimum alcohol content of more than 39°. Furthermore, domestic brands of high strength spirits of more than 39° such as gin, vodka, rum or whisky are generally low quality products positioned at the low end of the market. So-called "Chilean whisky" is a case in point. According to the International Wine and Spirits Record, the largest part of Chile's "whisky" production is used for re-filling bottles of imported brands.²⁴⁰ This is not the type of "domestic production" which a Government may be interested in protecting.

4.495 **Chile replies** that in assessing effects of the New Chilean System, the European Communities asks the Panel to look only at existing EC production that would face high taxes and existing Chilean production that would face relatively lower taxes. As just noted, that ignores both the EC production that would face low taxes if exported to Chile and the substantial Chilean production that will face relatively high taxes.²⁴¹ The European Communities already produces grappa, for example, a spirit distilled from grapes that is quite similar to pisco, and it could readily be marketed in Chile, if the EC producers so chose. In addition, nothing under Chilean law prevents the EC producers of spirits from diluting their products to a lower alcohol strength and commercializing them in Chile provided that they comply with the provisions of the Chilean law regarding health and food. In that very real sense, the European Communities has the equality of competitive opportunities which it claims to seek. Very simply, the New Chilean Law applies to and affects domestic producers of spirits in the same manner as it applies to and affects importers of alcoholic beverages. It in no way prevents foreign producers of spirits from importing any low alcohol content spirits benefiting from a lower level of taxation on the basis of their alcohol content.

4.496 **The European Communities further responds** that Chile also argues that the New Chilean System is "neutral" because there are some imports in the less taxed category. The actual fact, however, is that imports of spirits with a minimum alcohol content of 40° account for 95 % of imports.

²³⁸ Ibid.

²³⁹ Chile First Submission, Annex III.

²⁴⁰ EC Exhibit 19, p.43.

²⁴¹ Chile argues that local production accounts for 71.6% of the alcoholic beverages with alcohol content of more than 39° in 1995, which will be subject to the highest rate of taxation under the New Chilean System.

In practice, the only imported products which could benefit from the lowest tax rate in the New Chilean System are certain types of low strength liqueurs.²⁴²

4.497 In the view of the European Communities, Chile's assertions to the effect that in previous cases the favoured product was always one that "could be only domestic" misrepresent the findings of those reports. For example, just like Chile in this case, Japan claimed that its tax system was "neutral" because shochu was not an "inherently" Japanese product.²⁴³ Indeed, there were imports of shochu into Japan.²⁴⁴ Furthermore, the panel accepted the evidence submitted by Japan according to which shochu was produced in substantial quantities outside Japan, in countries such as Korea, China, Singapore and even the United States.²⁴⁵ Similarly, in *Korea – Taxes on Alcoholic Beverages*, the panel based its conclusion that the measures were protective on the fact that the current volume of imports of soju were very small, and not on the fact that soju was an "inherently" Korean product.²⁴⁶

4.498 The European Communities continues to state that in the same vein, Chile argues that in *United States – Malt Beverages*, the small breweries exception was found to violate Article III:2 because "only small US breweries could qualify". This is a gross misrepresentation of the panel's findings. The panel did not condemn the small brewery exception because it was not available to foreign products, but because beer from small breweries is "like" beer from large breweries, and Article III:2, first sentence, does not tolerate any tax differential between "like" products:

The Panel further noted that the parties disagreed as to whether or not the tax credit in Minnesota were available in the case of imported beer from small foreign breweries. The Panel considered that beer produced by large breweries is not unlike beer produced by small breweries Therefore, in the view of the Panel, even if Minnesota were to grant the tax credits on a non-discriminatory basis ... there would still be an inconsistency with Article III:2, first sentence.²⁴⁷

4.499 In the view of the European Communities, Chile's argument turns upside down the well-established principle that Article III is concerned with the protection of competitive opportunities and not of actual trade flows.²⁴⁸ The thrust of that principle is that in order to establish a violation of Article III:2, it is not necessary to show that a measure has actually restricted imports. A violation of Article III:2 may be found even if there are no imports at all. It is sufficient to show that the measure may limit potential imports. Chile subverts this principle by arguing that the fact that actual imports are restricted is irrelevant, if potential imports of a different product are not.

4.500 Further, the European Communities states that Chile's argument does not take into account the specific nature of the products at issue. Spirits are not commodities. Spirits are "experience goods"²⁴⁹, whose consumption is largely based on habit. For that reason, market penetration tends to be slow and requires considerable marketing efforts. It may require some time and advertising expenditure to convince a hardened pisco drinker to switch to whisky, just as it may require some time and advertising to convince a smoker of Camel to try Marlboro. Even though all distilled spirits and liqueurs are, by reason of their physical characteristics and potential end-uses, "directly competitive or substitutable" products, currently the main competitive threat to pisco comes from

²⁴² The European Communities notes as regards grappa that it should be noted that in the European Communities its minimum alcohol content is 37.5 % vol. Therefore, it would have to be diluted in order to benefit from the lowest tax rate in Chile.

²⁴³ See Panel Report on *Japan - Taxes on Alcoholic Beverages II*, *supra.*, paras. 4.19 and 4.175-4.179.

²⁴⁴ *Ibid.*, para. 4.177.

²⁴⁵ *Ibid.*, para. 6.35.

²⁴⁶ Panel Report on *Korea - Taxes on Alcoholic Beverages*, *supra.*, para. 10.102.

²⁴⁷ Panel Report on *United States - Malt Beverages*, *supra.*, para. 5.19.

²⁴⁸ Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II*, *supra.*, p.16.

²⁴⁹ See Panel Report on *Korea - Taxes on Alcoholic Beverages*, *supra.*, para. 10.75.

whisky and the other high strength spirits which are already present in the Chilean market. It could take many years before other (low strength) spirits which are currently not exported to Chile, or only so in small quantities, could represent a comparable threat for pisco. Thus, the New Chilean System does afford effective protection to pisco even if it does not protect pisco against potential imports of low strength spirits.

4.501 **Chile further responds** that the European Communities itself has made an analogy between type names such as whisky, vodka, shochu, etc, and brandnames, such as Camel or Marlboro cigarettes. The analogy is correct, at least insofar as the laws would prevent a whisky producer from calling his product vodka, just as the intellectual property laws of most countries would prevent Camel from calling its cigarettes Marlboros, or, for that matter, a sparkling wine producer from Italy or Chile calling its product Champagne in the European Communities.

4.502 According to Chile, the panels in the Korean and Japanese cases decided that tax distinctions based on such type distinctions are not permissible, if the two types of product are directly competitive or substitutable and if they are dissimilarly taxed, and if that dissimilar taxation creates a favoured group that is essentially all produced domestically. In other words, a distinction that may be perfectly acceptable, indeed mandated for purposes of marketing products under a certain name, cannot be used to justify tax or regulatory distinctions under Article III if the named products are otherwise directly competitive or substitutable and the other tests of an Article III violation are met.

4.503 Chile states that it does not contest that thesis. Indeed, distinctions based on intellectual property, or subjective classification systems could be very harmful to a developing country such as Chile if used to discriminate against Chilean products. Products that may qualify to be treated differently for intellectual property or similar purposes may still be directly competitive or substitutable for Article III purposes.

4.504 Chile claims that in this dispute, however, the European Communities is not simply asking the Panel to prohibit tax distinctions based on type names. Indeed, Chile has done that, eliminating all distinctions based on types of distilled spirits. The European Communities is asking this Panel to take the interpretation of Article III significantly farther so as to create an affirmative obligation for WTO members to ensure that their internal taxes accommodate precisely the same marketing standards that the European Communities insists are insufficient to make the products not directly competitive or substitutable. For the European Communities, it is not sufficient to abandon tax distinctions that are based on concepts such as types or brands. The European Communities argues that the tax laws and regulations must not have the effect of diminishing whatever marketing or intellectual property value is thought to be associated with the name or brand.

4.505 Chile further contends that this theory would go too far as a matter of interpretation of Article III. It is one thing to say that qualitative distinctions, even though sought by the industry and mandated by law or regulation, are not necessarily sufficient to justify tax or regulatory distinctions that otherwise would violate Article III. It is quite another thing to say that Article III carries an implicit obligation affirmatively to protect or enhance such an intellectual property right or subjective classification system.

4.506 In the view of Chile, primarily at the urging of the European Communities and other developed countries, the WTO now includes the TRIPS Agreement. The European Communities is free, if it wishes, to seek to negotiate further intellectual property rights and protections, such as a right to market under type names like whisky with high minimum alcohol requirements and immunity from adverse tax consequences flowing from that high alcohol content. But there is no basis for attributing such an obligation to Article III of GATT 1994.

4.507 Chile reiterates that in the meantime, under the New Chilean System, EC producers will have the same choice as Chilean producers and all third-country producers of alcoholic beverages. They can sell products that already are of low alcohol strength at the lowest rate of taxation. They can sell high alcohol products without dilution, but also without discrimination between domestic and imported product and, in the case of whisky, at a substantially lower tax rate than has prevailed. They can also elect to dilute their high alcohol products with a relatively small amount of water and similarly benefit from low taxation. Despite the EC's protestations, Chile cannot fail to note that dilution with water is hardly an onerous process for a product that, in the EC's words, is already "99% water and alcohol" and whose last stage of production is already dilution with water to the desired alcohol strength. Further, the European Communities itself has noted the large tendency for consumers themselves to dilute their product with water, ice, or various mixers.

4.508 Chile notes that, even after dilution, Chile's intellectual property laws will protect the EC's trademarks in Chile, whether those producers market their brands as whisky or some other product. Chile has a chart demonstrating various diluted alcoholic beverages on sale in Chilean supermarkets, using their brandnames and the alcoholic beverage with which they are mixed, as indicated in Table 38.

Table 38²⁵⁰

<u>Diluted Alcoholic Beverages</u>			
Beverage	Alcohol Content	Brandname	Origin
Margarita	13	Careye's	Mexico
Vodka and peach	25	Artic	Italy
Vodka and coconut	25	Artic	Italy
Vodka and melon	25	Artic	Italy
Vodka and apple	25	Artic	Italy
Vodka and pineapple	30	Artic	Italy
Vodka and cranberry	30	Artic	Italy
Lemon rum	35	Finlandia	Finland
Pisco sour	22	La Serena	Chile
Pisco sour	22	Capel	Chile
Pisco sour	22	Control	Chile
Pina colada	20	Mitjans	Chile
Whisky and cola	8	Jack Daniel's	U.S.A.
Cola de mono	16	Vina Mendoza	Chile

(d) Percentage of More Taxed Products in Imported Products

4.509 **The European Communities further points out** that in contrast, nearly all imports of spirits will be taxed at the highest rate. As shown in Table 19 above, imports of whisky, gin, vodka, rum and tequila (all of which will be taxed at the rate of 47 % *ad valorem*) account for more than 95 % of imports of spirits into Chile.

²⁵⁰ Chile Oral Statement at the Second Substantive Meeting, Table I-A.

4.510 The European Communities contests the Chile argument that the New Chilean System is "neutral" because some domestic production will be taxed at the highest rate. In reality, however, the share of current domestic production falling within the most taxed category is relatively small: between 15 % and 25 %. Furthermore, sales of domestic spirits with a minimum alcohol content of more than 35° represent as little as 6 % of total domestic production. In turn, domestic spirits with a minimum alcohol content above 39° account for barely 2.7 % of total domestic production, based on the data shown in Table 19 above. Thus, potentially nearly all domestic production of spirits qualifies for the lowest or the intermediate tax rate. For comparison, in *Japan – Taxes on Alcoholic Beverages I* and *II*²⁵¹, the share of domestic production falling within the less taxed category was 80 %.

4.511 The European Communities also considers that in any event, as Chile itself has acknowledged, previous panel reports confirm that the presence of some domestic production in the most taxed category does not exclude a violation of Article III:2, second sentence. Thus, for example, in *Japan – Taxes on Alcoholic Beverages II*²⁵², domestic production accounted for no less than 75 % of the sales of whisky, 72 % of the sales of brandy, 82 % of the sales of spirits and 97 % of the sales of liqueurs. In *Korea – Taxes on Alcoholic Beverages*, 80% of gin, 50 % of rum and 30 % vodka were imported.²⁵³ What really matters is whether the majority of domestic production falls within the favoured category.

4.512 The European Communities further claims that unlike pisco those spirits do not have the flexibility to move down the scale in order to benefit from the lowest tax rate. In conformity with Chilean regulations, all of them must be bottled at a minimum alcohol content of 40° and, therefore, are automatically locked in to the highest rate of 47 %.

4.513 **In rebuttal, Chile contests** the EC complaint that Chilean Law 18,455 will prevent producers of distilled spirits such as whisky, gin and rum from marketing their products at the lowest rate of taxation, because Chilean regulations under that law established minimum alcohol standards for those products that preclude sale at less than 40° of alcohol. That misstates the requirements of Chilean Law 18,455 and regulations thereunder, which in any event are not at issue in this dispute. It is true that products cannot be marketed, for example, as "whisky" unless the product contains at least 40° alcohol. However, there is nothing in Chilean law or regulations that preclude a whisky producer from adding water to the product to reduce its strength to 35° before bottling, so long as the product is not marketed as whisky.

4.514 In the view of Chile, while producers of whisky (or rum, gin, etc.) might prefer to market their products under the traditional type name, those producers cannot have it both ways when seeking the benefits of Article III. The distilled spirits industry cannot insist when taxation is at issue that all distilled spirits products be treated in the identical way as measured by whatever standards of equivalency best suit the commercial interests of the large export industries, but then claim at the same time that fine distinctions between essentially identical products, often based almost exclusively on origin or minute differences of process or ingredients, be vigorously enforced and accommodated.

4.515 Chile goes on to state that whisky producers in Europe, like whisky producers in Chile, cannot market their product as whisky in Chile unless it is at least 40° alcohol by strength. That is a requirement of both European Communities and Chilean regulations, and in both cases it is applied

²⁵¹ Panel Report on *Japan - Taxes on Alcoholic Beverages II*, *supra.*, para 4.95.

²⁵² *Ibid.*, Annex IV.

²⁵³ See Panel Report on *Korea - Taxes on Alcoholic Beverages*, *supra.*, para. 3.17.

equally to imported and domestic products. That is, a product that is "like" whisky in every way but its alcohol strength cannot be marketed as whisky.²⁵⁴

4.516 Chile states that it is ironic that the European Communities also requires minimum alcohol levels in order to be able to market products in the Community as different kinds of spirits. For example, the commercially desirable name of Scotch whisky can only be applied to a product that meets the minimum alcohol standard imposed by the European Communities²⁵⁵, as also confirmed by the ECJ.²⁵⁶ An imported product that is identical in every other way cannot use this desirable term Scotch whisky if it has one percent less alcohol than the minimum -- yet, such distinctions have not been considered to violate Article III:4 requirements for no less favorable treatment with respect to internal laws, regulations and requirements.

4.517 According to Chile, the EC's own practice under the national treatment provisions of the Treaty of Rome has developed in such a way that, according to the European Communities, "Article III:2 of GATT contains provisions broadly corresponding to Article 95 [EEC]".²⁵⁷ In interpreting the national treatment rules of Article 95 of the Treaty of Rome, the European Court of Justice stated that:

In the present state of Community law Article 95 EEC does not prohibit Member-States, in the pursuit of legitimate economic or social aims, from granting tax advantages, in the form of exemptions from or reduction of taxes, to certain types of spirits or to certain classes of producers, provided that such preferential systems are extended without discrimination to imported products conforming to the same conditions as the preferred domestic products.²⁵⁸

4.518 Chile states that it is interesting to note that the European Court of Justice decided that:

A system does not favor domestic producers if a significant proportion of domestic production of alcoholic beverages falls within each of the relevant tax categories.²⁵⁹

4.519 Chile goes on to state that the same can be inferred from a *contrario* analysis of the European Court of Justice ruling that:

[A] criterion for the charging of higher taxation which by definition can never be fulfilled by similar domestic products cannot be considered to be compatible with the prohibition of discrimination laid down in Article 95 of the Treaty ...²⁶⁰

4.520 Thus, Chile mentions that the European Communities recognizes that "Article III:2 is concerned with the protection of competitive *opportunities* and not of *actual* competition". (emphasis

²⁵⁴ Council Regulation 1576/89 of 29 May 1989 Establishing General Rules on the Definition, Description and Presentation of Spirits, Art. 5, 1989 J.O. (L160) 1.

²⁵⁵ Ibid.

²⁵⁶ Case C-136/96, *Scotch Whisky Association v Compagnie Financiere Europeenne de Prises de Participation*, 696J0136, 1998 ECJ Celex Lexis 1211 (16 July 1998).

²⁵⁷ Case 148/77, *H. Hansen jun. & O. C. Balle GmbH & Co. v Hauptzollamt Flensburg*, 1978 E.C.R. 1787, 1 C.M.L.R. 604 (1979).

²⁵⁸ Case 196/85, *Natural Sweet Wines: Commission v. France*, 1987 E.C.R. 1597, 2 C.M.L.R. 851 (1988); See also, Case 127/75, *Bobie Getrankevertrieb GmbH v Hauptzollamt Aachen-Nord*, 1976 E.C.R. 1079; and Case 148/77, *H. Hansen jun. & O.C. Balle GmbH & Co. v. Hauptzollamt Flensburg* 1978 E.C.R. 1787, 1 C.M.L.R. 604 (1979).

²⁵⁹ Case 243/84, *John Walker & Sons Ltd v. Ministeriet for Skatter og Afgifter*, 1986 E.C.R. 875, 2 C.M.L.R. 278.

²⁶⁰ Case 319/81, *Commission v Italy*, 1983 E.C.R. 601, 2 C.M.L.R. 517, para. 17.

supplied by Chile) It is clear from the preceding arguments that EC producers of alcoholic beverages have the same competitive opportunities as domestic producers of spirits and it is up to EC producers to seize the opportunities that the New Chilean System offers them.

4.521 Chile contests the objection of the European Communities that the New Chilean System results in relatively high taxes on many imports and relatively lower taxes on many domestic products. That may be true, assuming that the current configuration of EC (and Chilean) production continue. But it is equally true that the New Chilean System results in relatively high taxes of high alcohol premium domestic products, which constitute a substantial and growing segment of Chilean production, a pattern of consumption which is consistent with the level of distribution and income of a developing country. In fact the New Chilean System is biased in tax terms against relatively high alcohol products and against relatively expensive products, but that does not constitute a violation of the "so as to afford protection to domestic production" standard.

4.522 Chile argues that it is also essential to note in this regard that, unlike systems based on distinctions between different types of distilled spirits, it is a relatively simple matter for foreign and domestic producers to adapt to the neutral and objective standards of the Chilean system. A whisky producer cannot readily become a pisco producer, but a producer of any spirit of 40° alcohol can readily dilute the product to 35°. The European Communities already produces many products (grappa, fruit liqueurs, etc.) that qualify for the lowest taxes and even more products that would qualify if only, as the European Communities suggests be done for pisco,²⁶¹ some water is added to the current high alcohol products before bottling. Article III simply does not obligate sovereign Member governments to harmonize their neutral taxation system to the convenience of foreign producers in the way sought by the European Communities in this case. The New Chilean System affects domestic producers of spirits in the same manner as it affects importers of alcoholic beverages, and does not prevent foreign producers of spirits from importing any low alcohol content spirits benefiting from a lower level of taxation on the basis of their alcohol content.

4.523 In the view of Chile, the overriding requirement of Article III:2 is not to discriminate in favor of domestic goods and against imported goods on the basis of national origin of a product. Almost all cases brought to GATT and WTO panels under Article III:2 have involved measures that, on their face, afforded more favorable treatment to some or all domestic goods than to imported goods.

4.524 Chile states that a legislator should also be aware that a measure that formally does not discriminate based on nationality may nevertheless be found to contravene Article III:2, second sentence, if the effect of the measure is to make more favorable treatment available exclusively or virtually exclusively to domestic products to the disadvantage of imported products. GATT and WTO panels have gone furthest in extending the concept of *de facto* discrimination based on national origin of a product in the recent alcoholic beverage taxation cases against Japan and Korea. Both of those countries had tax systems in which one type of distilled spirit was taxed at a far lower rate than other distilled spirits. Further, in each case, domestic producers accounted for virtually all domestic consumption of shochu or soju, because various measures effectively prevented imports of shochu/soju from competing in the domestic market. In these circumstances, where there was no possibility for foreign producers to obtain the benefits of the low tax accorded to shochu/soju, and where the panel found that the favoured product was like or directly competitive or substitutable with other types of distilled spirits, these systems were held to contravene Article III:2.

4.525 Chile goes on to state that on the other hand, laws and regulations based on objective criteria such as those used in the New Chilean System have rarely been challenged in the GATT and have

²⁶¹ Chile notes that producers of pisco reservado or gran pisco might choose not to dilute, because they would then lose the right to market under those more prestigious names, which are also associated with more elaborated processes and select ingredients.

never been successfully challenged, even when the tax system may result in less favorable treatment for some or many imported goods than for some or many domestic goods. For example, in the *United States - Taxes on Automobiles* case, the panel found that the United States had *not* breached Article III:2 by imposing a luxury tax on vehicles above a certain threshold value.²⁶² The U.S. tax resulted in far higher taxes on certain European products, which dominated the U.S. market for cars priced significantly above the threshold price and thus the vast majority of the revenue collected from the tax on European cars. However, far more imports, including a significant number of imports in the price categories most directly competitive with U.S. "luxury cars," paid a minimal tax or no tax at all.

4.526 Chile states that while the reasoning of the *United States - Taxes on Automobiles* Panel (the so-called "aims and effects" test) was not followed subsequently by the Appellate Body, Chile believes that the result would have been the same under the three part test applied by the *Japan – Taxes on Alcoholic Beverages II* Appellate Body.²⁶³ The luxury tax imposed by the United States was based on objective criteria (a tax on the value of cars in excess of a fixed luxury level) that applied to both domestic and imported cars, and imported cars could and did benefit from the tax exemption granted to all cars below the exemption.

4.527 Chile further argues that comparing that system to the Chilean system of taxation of alcoholic beverages, it might be noted that it is easier as a practical matter for foreign producers to adapt the alcohol strength of their product than for car producers to reduce their prices.

4.528 Also, Chile maintains that similarly, even though specific taxes such as those imposed on alcoholic beverages in several EC Member States have a marked discriminatory effect on low priced imported products relative to high priced domestic products such as Scotch whisky or even imported high priced products such as U.S. or Canadian whisky, Chile has believed that a challenge of such tax systems under Article III (or Article I which requires most favoured nation treatment with respect to matters covered by Article III:2) would probably not be successful because the tax standard is objective, even if its effect disfavors low price products.

4.529 Chile notes that it is likewise inconceivable that members of the WTO, particularly developing country members, thought or think that, in joining the WTO and accepting thereby the obligations of Article II:2, they were foregoing the right to use fiscal policy tools such as luxury taxes or exemptions or reduced taxes for goods purchased primarily by poor consumers, even if such policies result in higher taxes on many imports than on many like or directly competitive products.

4.530 Chile believes that the European Communities errs in the following principal ways chiefly because the European Communities ignores significant differences between the Chilean law and market and those of Japan and Korea or because the European Communities tries to equate differences between the Chilean and EC systems of taxation with a violation of Article III:2.

4.531 Chile argues that the European Communities ignores that, unlike the situation under the Japanese and Korean Systems, imported products can readily benefit from the lowest rates of taxation in Chile.

4.532 In the view of Chile, the European Communities accepts taxation based on alcohol content, but tries to argue that such taxes must be both specific and strictly proportional to alcohol content, when such a test is not required by Article III, not equitable by many standards, and not consistent with wine tax policies and policies such as luxury taxes.

²⁶² Panel Report on *United States - Taxes on Automobiles*, *supra*.

²⁶³ See Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II*, *supra*.

4.533 According to Chile, the European Communities asks this Panel to assess the Chilean objective tax system in terms of its effect on precisely the subjective categorisation system that is abandoned in the New Chilean System.

4.534 Chile maintains that having successfully argued in the Japan and Korea cases that a subjective system for typing and naming products cannot necessarily justify different treatment of those products under Article III:2, the European Communities now tries to argue that there is an affirmative duty to ensure even objective criteria -- such as those employed by Chile -- accommodate the subjective marketing system. This is tantamount to creating a new intellectual property right and insisting that Article III affirmatively protect that right.

4.535 Chile considers that panels and the Appellate Body applied the broadest interpretation of Article III:2 in the recent cases against Japanese and Korean alcoholic beverage taxes. In those cases, the measures in question were held inconsistent with Article III:2, second sentence, even though:

- (i) there was no explicit discrimination based on nationality; and
- (ii) at least in the case of Japan, there was very substantial domestic production of unfavourably taxed products that the panel found to be directly competitive or substitutable.

4.536 Then Chile argues that though those elements might suggest a non-discriminatory system, there were critical additional aspects to both systems. In those cases, the tax systems of Japan and Korea discriminated according to **type** of distilled spirit, and the type that was most favorably taxed was virtually entirely insulated from import competition. That is the element that does not exist in the New Chilean System.

4.537 In the view of Chile, the European Communities criticised Chile because it mis-described shochu and soju as "inherently" domestic products. Indeed, that was not the panel finding in either case. Instead the panel found that those particular types of distilled spirits in those countries were essentially insulated from import competition by Japanese and Korean measures. Thus imports could not benefit from the lower rate of taxation. They could not benefit by producing shochu or soju, because those products effectively could not be imported. They could not benefit otherwise, because only the product named shochu or soju could benefit, and the criteria for using those names did not allow adaptation of other products to qualify as shochu/soju.

4.538 Chile notes that the European Communities also seems to imply that there was an opportunity for imports to take advantage of the low tax category in the Korean and Japanese systems, when in fact the panels found quite the contrary. Notwithstanding the existence of productive capacity abroad, the panel found that domestic production of shochu and soju were insulated from that competition. Foreign shochu/soju producers could not enter the relevant markets because of trade restrictions, and foreign producers of other distilled spirits could not alter their products to make them into shochu or soju. Whisky could not be diluted into soju or shochu, and Vodka could not simply rename itself without changing its production method and becoming subject to essentially insuperable trade barriers.

4.539 Chile argues that by contrast, the Chilean system, using alcohol content without type distinctions, allows imports to take advantage of the low tax category of Chile.

4.540 Chile thus concludes that the Japanese and Korean systems employed subjective distinctions, while the Chilean System is objective. Use of type names to make tax categories had the effect in Japan and Korea of excluding from the lowest tax category distilled spirits not meeting the standards to be called shochu or soju. At the same time, import restrictions prevented products that could qualify as soju or shochu from entering. Thus, once the panel determined that shochu and soju were

competitive or substitutable with other products, the panel could also conclude that a virtually exclusively domestic product was being afforded protection by dissimilar taxation.

4.541 **In rebuttal, the European Communities stresses** the unequal impact of the measure on imported as compared to domestic products. The measure's structure ensures that between 75 % and 85 % of Chile's domestic production of spirits (including more than 90 % of all pisco sales) will be eligible for the lowest tax rate possible. In contrast, 95 % of imported products (including all imports of whisky, vodka, rum, gin and tequila) will be taxed at the highest rate possible.

4.542 In the view of the European Communities, Chile has not challenged those figures. Still, Chile pretends that the measure affords the same competitive opportunities to the EC exporters than to the Chilean producers of pisco. According to Chile, the EC exporters of whisky could take advantage of the lowest rate simply by diluting their whisky to 35°. Yet, that diluted beverage would no longer be considered as whisky in most countries. In Chile itself, the law prescribes that whisky must have no less than 40°. This means that if the EC producers diluted whisky to 35°, the resulting product could not be sold under the term "whisky". As mentioned before, the same minimum alcohol content requirement applies also to gin, rum, vodka and tequila.

4.543 The European Communities notes that likewise, the fact that a few imports of low strength liqueurs will benefit from the lowest tax rate does not exclude a violation of Article III:2, second sentence. The possibility to dilute high strength spirits to 35° is not a real option for the EC spirits producers. To begin with, because by doing so the EC producers of spirits would forfeit the right to sell their products under their traditional, well reputed names. Moreover, the degree of alcohol content is one of the essential features which define the identity of each type of spirit. Whisky drinkers would simply not consider diluted whisky as real whisky.

4.544 The European Communities states that it seems almost unnecessary to state that this is not really an option for the EC producers of spirits. In the first place, as acknowledged by Chile, whisky, vodka, gin, rum and tequila (which together account for 95 % of imports) simply could not be lawfully marketed at 35° or less, unless at the price of losing their names.

4.545 The European Communities notes that Chile seems to consider as an obvious fact that foreign producers "could not hope to sell something called shochu in the Japanese or Korean market". On the other hand, it pretends that selling in Chile something called "*aguardiente de cereales*" would be no more difficult than selling something called "whisky". This is incorrect. "Whisky", "rum", "gin", "vodka" and "tequila" are all well-established product names which enjoy worldwide consumer recognition. In order to build up a totally new product name with the same reputation as "whisky", the EC producers would have to invest considerable financial resources over a long a period of time. Asking the EC producers to forfeit the prestigious name "whisky" in order to qualify for the lowest tax rate amounts to asking them to write off all their previous marketing efforts in Chile. If Chile is truly convinced that the use of a well-known and reputed name does not improve the "competitive opportunities" of a spirit, why does it insist on reserving the name "pisco" exclusively for domestic pisco?

4.546 The European Communities further notes that Chile quotes the following passage of the ECJ decision in the Case 319/81, *Commission v. Italy*, as supporting *a contrario* Chile's argument that the presence of domestic products in the more taxed category excludes protective application:

... a criterion for the charging of higher taxation which by definition can never be fulfilled by similar domestic products cannot be considered to be compatible with the prohibition laid down in Article 95 of the Treaty ...

4.547 In the view of the European Communities, Chile's argument provides an excellent illustration of the well-known fact that *a contrario* inferences are often wrong. It is obvious that from the fact that a condition which cannot be fulfilled by domestic production is contrary to Article 95 ECT, it cannot be logically inferred that all other conditions are always compatible with Article 95. By now, it is a well-established principle of both EC law and GATT law that *de facto* discrimination (as opposed to *de jure* discrimination, including indirect *de jure* discrimination such as the one at issue in Case 319/81) is contrary to Article 95 of the Treaty of Rome and Article III GATT, respectively.

4.548 The European Communities further argues that on the other hand, it is worth noting that this ECJ judgement refutes Chile's dilution argument. The measure in dispute in case 319/81 was the application by Italy of the VAT at a higher rate on spirits which benefited from a designation of origin (e.g., Cognac). This condition could not be met by domestic production, because Italian law does not recognise designations of origin for spirits. If one follows Chile's logic, there would be no violation of Article 95, because foreign producers could avoid paying the higher tax simply by selling their products under a generic name. For instance, the exporters of cognac would have qualified for the lowest rate simply by selling its product under the name "wine brandy", something which according to Chile would not have impaired their competitive opportunities.

4.549 According to the European Communities, moreover, even if Chilean regulations were amended so that whisky, gin, rum, vodka and tequila could be lawfully marketed at 30°-35° without forfeiting their name, the New Chilean System would still fail to afford "equality of competitive opportunities". Contrary to Chile's argument, minimum alcohol standards are not a capricious invention of some wicked multinationals. The level of alcohol content is one of the essential characteristics which define the identity of each type of spirit. Consumers associate each type of spirit with a certain range of alcohol content. For many whisky consumers, whisky of 30° would simply not be "real" whisky, irrespective of the name written on the label. It is in recognition of this fact that the regulations of both Chile and the European Communities, and of many other countries, prescribe a minimum alcohol content for whisky of 40°. ²⁶⁴

4.550 The European Communities also argues that in practice, by putting forward its dilution suggestion Chile admits that its New Chilean System places foreign producers in the following dilemma. Those producers can either choose to preserve their products' name, as well as the properties with which they are traditionally known in Chile and worldwide at the cost of being subjected to higher tax rates. Or they can obtain a more favourable tax treatment, but at the price of losing both the product's name and the product's identity.

4.551 The European Communities further claims that that sacrifice is not required of the producers of pisco. Indeed, pisco does not need to forfeit its name or suffer any alteration of its traditional characters in order to benefit from the lowest tax rate and thus can "have it both ways".

4.552 According to the European Communities, already more than 90% of pisco is 35° or less and, therefore, qualifies for the lowest tax rate. Moreover, pisco producers could dilute the remaining production to 35°, without losing the right to use the name "pisco". All they would lose is the right to use the names "*gran pisco*" and "*pisco reservado*". Those names enjoy less consumer recognition than names such as "whisky" and have only a limited commercial value.

4.553 In the view of the European Communities, moreover, unlike in the case of whisky and the other main types of imported spirits, a relatively high alcohol content is not one of the essential features that define the identity of pisco. To the contrary, traditional pisco is 30°-35° (recall that pisco of 30° to 35° is called precisely "*tradicional*"). Thus, consumers of pisco, unlike consumers of

²⁶⁴ See US Exhibit 1.

whisky, would be neither surprised nor disappointed by pisco diluted to 35°. Chile's argument to the effect that sales of high strength pisco have grown rapidly over the last decade only serves to underscore that high strength is not one of the traditional characteristics of pisco. The growth of high strength pisco is the result of a relatively recent marketing strategy which could be easily reversed so as to take advantage of the lowest tax rate.

4.554 Further, the European Communities maintains that the positions taken by the pisco industry during the process leading to the adoption of the New Chilean System confirms beyond any possible doubt that, for the pisco industry, the "sacrifice" of *gran pisco* and *pisco reservado* is indeed a small one, compared to the benefit they derive from the application of a higher tax rate to whisky. As explained below, the pisco industry petitioned the Chilean Parliament to increase the tax rate on spirits of 40° (including *pisco reservado*) to 50% (instead of 45%, as proposed by the Government) and the rate on spirits of 43° (including *gran pisco*) to 73% (instead of 65%). Later on, the pisco industry opposed an amendment of the Government proposal that would have lowered the rate on both *pisco reservado* and *gran pisco* to 40-45% (instead of 50 % and 65 %, respectively, as proposed originally by the Government).

4.555 In the view of the European Communities, the truth of the matter is that the Chilean Government does not really believe that dilution is a realistic option for the EC spirits producers. The "dilution" argument is but an *ex-post facto* rationalisation. When estimating the impact on the level of tax revenue of the New Chilean System, the experts of the Chilean Ministry of Finance assumed that all whisky would continue to be sold at the same strength as before. Chile now describes that assumption as "arbitrary". However, given that maintaining the level of tax revenues is one of Chile's paramount objectives, making that assumption would have been not only "arbitrary" but also irresponsible.

4.556 **Chile replies** that as can be seen in the EC's own Table 8 above, the last stage of production of distilled spirits of virtually every kind is to add water to achieve the desired alcohol strength. EC producers have themselves produced lower alcohol versions of virtually all types of spirits sold in the European Communities, and could do so again.

4.557 Chile notes that the European Communities and the intervening parties have objected that they do not want to have to dilute their products further in order to qualify for a lower tax rate in Chile, and that EC and Chilean regulations would preclude marketing their products under certain type names unless minimum alcohol strength requirements for those types are observed. Chilean producers of *Pisco Reservado* and *Gran Pisco* have made the same objection. However, neither the Chilean nor the EC regulations governing minimum alcohol contents for marketing distilled spirits under particular type names are at issue in this Panel proceeding. Further, Article III does not require WTO members to design their laws and regulations to accommodate the manner or name under which foreign producers might prefer to market their products. The benefit of marketing under particular type names such as *Gran Pisco* or whisky is similar to the benefits from marketing under marks of origin or trademarks. Article III does not require protection or accommodation of rights or regulations, so long as the law does not impose discriminatory restrictions.

4.558 In the view of Chile, some producers also complain that dilution with water will affect the taste of their products. However, most products are consumed diluted by the consumer. Producers of the few products that are most often consumed undiluted (such as cognac or *Gran Pisco*), may decide not to lower their alcohol content, but these products tend all to be taxed with one another at the highest tax level in any case. In its support, Chile refers to Table 38 above.

(e) Position of Domestic Industry toward New Chilean System

4.559 **The European Communities claims** that the terms of Law 19,354 were negotiated and agreed formally by the Government with the pisco industry and are largely responsive to the interests and demands of that industry. As discussed below, those demands were by no means circumscribed to the level of the taxes applied to pisco.

4.560 **Chile replies** that the European Communities devotes many pages to an entirely irrelevant description of past taxation of alcoholic beverages in Chile and an even longer and also irrelevant purported "drafting history of Law 19,534," in which the European Communities claims to know the Chilean legislative process and even motivations of elected officials and industry groups. The "drafting history" is particularly curious, in that the European Communities apparently intended to try to establish protectionist motivations, but even the selective and partial record to which the European Communities refers includes ample demonstration that the motivation of many legislators was to remove discrimination and protectionism in the old system that the European Communities had previously attacked.

4.561 In the view of Chile, in any event, the previous tax system of Chile and the motivations of Chilean legislators and industries are not at issue in this dispute, nor are they relevant to the interpretation of Article III:2.

4.562 **The European Communities alleges** that Law 19,534 was adopted in an attempt to address longstanding complaints from the European Communities and other WTO members to the effect that the ILA was contrary to GATT Article III:2. The European Communities had requested formal consultations with Chile under GATT Article XXIII with respect to the ILA already in 1989.²⁶⁵ Following the conclusion of the Uruguay Round, the European Communities renewed its requests to Chile to bring the ILA in conformity with its GATT obligations. The EC complaints were expressly mentioned in the message of the President of the Republic attached to the first of the Executive's proposals for amending the ILA²⁶⁶ and were extensively discussed during the subsequent debate by the Chilean Congress.

4.563 In the view of the European Communities, at first, the pisco industry and the representatives of the *zona pisquera* in Congress were opposed to any modification of the ILA. Eventually, however, even the pisco industry accepted that an amendment of the ILA was inevitable in order to avoid an outright condemnation of Chile in the WTO. The Foreign Relations Minister Mr Insulza summed up accurately the prevailing view in Chile when, following a meeting with representatives of the pisco industry, he declared that "consensus exists that the current legislation is discriminatory and a change must be made"²⁶⁷. Similarly, during the debate by Congress of Law 19,534, many legislators (including the representatives of the *zona pisquera*) admitted openly that a reform of the ILA was necessary because the existing legislation was "discriminatory" and "favoured" the pisco industry.²⁶⁸

4.564 The European Communities then argues that although the pisco industry realised that it was no longer possible to maintain the formal discrimination between pisco and other spirits, it had no intention to renounce the protection which it had enjoyed for decades. Rather, according to the European Communities, the objective of the pisco industry was to perpetuate the tax differentials between pisco and other spirits in a less conspicuous manner. The European Communities argues that the process of amendment of the ILA was driven by the purpose to find a formula that, whilst being

²⁶⁵ Gatt doc. DS9/1.

²⁶⁶ Presidential Message No 78-332, 26 October 1995 (EC Exhibit 14).

²⁶⁷ *La Tercera*, 10 June 1997 (EC Exhibit 46).

²⁶⁸ See the Minutes of the debate by the Chamber of Deputies of 27 July 1997, EC Exhibit 16 and *Las Ultimas Noticias*, 7 November 1996, EC Exhibit 37, and *El Diario*, 13 February 1997 (EC Exhibit 41).

ostensibly less inconsistent with GATT Article III:2, allowed Chile to preserve to the largest extent possible the tax differentials between pisco and whisky.

4.565 The European Communities goes on to claim that in the course of that process, the Chilean Executive submitted two formal proposals for amending the ILA. The first proposal was tabled as early as October 1995²⁶⁹ (the "1995 Proposal"). That proposal was even more favourable to the interests of the pisco industry than the amendment eventually adopted in November 1997. As shown in Table 39, the 1995 proposal differed from Law 19,534 in three respects:

- (i) the rate on spirits of 35° or less was 25 % instead of 27 %;
- (ii) from that base, the rate increased in increments of 5 percentage points per each additional degree of alcohol content instead of 4 percentage points per degree;
- (iii) the tax rate continued to increase until 42° instead of peaking at 39°.

Table 39²⁷⁰

1995 Proposal for amending the ILA

<u>Alcohol strength</u>	<u>Tax rate <i>ad valorem</i></u>
Less or equal to 35°	25 %
Less or equal to 36°	30 %
Less or equal to 37°	35 %
Less or equal to 38°	40 %
Less or equal to 39°	45 %
Less or equal to 40°	50 %
Less or equal to 41°	55 %
Less or equal to 42°	60 %
Over 42°	65 %

4.566 According to the European Communities, in addition, the 1995 Proposal differed from Law 19,534 in that it did not envisage any transitional period. Instead, the new tax rates would have become applicable immediately after the entry into force of the amendment.

²⁶⁹ Presidential Message No. 78-332, 26 October 1995 (EC Exhibit 14).

²⁷⁰ EC First Submission, Table 8.

4.567 The European Communities argues that the 1995 Proposal was strongly supported by the pisco industry. That support was expressed at the hearing of interested parties held by the Committee on Foreign Relations of the Chamber of Deputies. On that occasion, the only request made by the pisco industry was that, between 35° and 42°, the tax rate should increase by 6 percentage points per each additional degree of alcohol instead of by 5 percentage points.²⁷¹ Had this demand been accepted, the applicable rate on *pisco reservado* would have been 55 % instead of 50 %, and the rate on *gran pisco* 73 % instead of 65 %. According to the European Communities, this request shows that Chile's pisco industry was more concerned by the reduction of the taxes applied to whisky than by the increase of the taxes on high strength pisco.

4.568 The European Communities further argues that, significantly, the 1995 Proposal was vigorously opposed by all the other interested parties that expressed their opinion before the Foreign Relations Committee. The opponents to the bill included not only the importers of spirits (represented by the *Asociación Nacional de Importadores*) but also the *Sociedad de Fomento Fabril* (the "SFF", Chile's federation of industrialists) and the *Asociación Gremial de Licoristas* (a trade association of liquor producers), as well as *Chile Vid* (the association of producers of fine export wines) and the *Asociación de Exportadores y Embotelladores de Vino* (the association of exporters and bottlers of wine).²⁷²

4.569 The European Communities further claims that according to the SFF, the 1995 Proposal was still contrary to GATT Article III:2 because although it "eliminate[d] the explicit discrimination against whisky ... it replace[d] it by disguised discrimination".²⁷³ Furthermore, both the SFF and the *Asociación Gremial de Licoristas* noted that the 1995 Proposal would give pisco even a greater advantage with respect to other spirits.²⁷⁴ Similar views were expressed by the producers and exporters of wine.²⁷⁵

4.570 According to the European Communities, the 1995 Proposal failed to attract sufficient support within the Foreign Relations Committee due to its perceived incompatibility with Chile's WTO obligations. According to the chairman of the Committee, Mr Renán Fuentealba, the 1995 Proposal:

... does not resolve the problem for Great Britain nor the WTO. We are not giving a voluntary political signal of eliminating the [tax] discrimination and we are running the risk that they will take us to a panel and we will lose.²⁷⁶

4.571 The European Communities goes on to argue that, confronted with the opposition of the Foreign Relations Committee, the Government announced that it would present to Congress an amendment ("*indicación*") to the 1995 Proposal providing for a larger reduction of the tax differential between pisco and whisky. According to press reports, the Government was envisaging to set the tax rate on whisky of 40° in the range of 40 % to 45 %, instead of at 50 %, as provided by the 1995 Proposal.²⁷⁷

²⁷¹ See the Report of the Committee on Foreign Relations, Inter Parliamentary Affairs and Latin American Integration, Bulletin No L732-05, dated 6 August 1996 (hereafter, "Report of the Committee on Foreign Relations"), p. 5. A translation into English is attached as EC Exhibit 17. See also Minutes, p. 16 (p. 2 of the English translation) (EC Exhibit 16).

²⁷² Report of the Committee on Foreign Relations, pp. 5-7 (EC Exhibit 17).

²⁷³ SFF's submission to the Committee on Foreign Relations, p. 6 (EC Exhibit 18).

²⁷⁴ Ibid., p. 7. See also the Report of the Committee on Foreign Relations, p. 6 (EC Exhibit 17).

²⁷⁵ Ibid., pp. 6-7 (EC Exhibit 17).

²⁷⁶ *El Diario*, 4 June 1996 (EC Exhibit 27).

²⁷⁷ *El Diario*, 23 de Julio 1996 (EC Exhibit 32).

4.572 The European Communities further contends that the pisco industry and the representatives in Congress of the *zona pisquera*²⁷⁸ staunchly resisted any such modification of the 1995 Proposal. In order to pre-empt the Government from presenting the announced amendment, the opposition parties forced a vote on the 1995 Proposal by the Foreign Relations Committee on 30 July 1996. This strategy failed because the members of the governmental coalition voted against the Government's own proposal.²⁷⁹

4.573 According to the European Communities, the support of the pisco industry to the 1995 Proposal was reiterated at a seminar of pisco producers organised by APICH (the national association of pisco producers) in La Serena in June 1996. Significantly, the seminar was entitled: "Pisco industry: challenges and threats". According to press reports, one of the main conclusions of that seminar was that :

[T]he pisco producers ... rejected any [modification by the Government] to its proposal to amend Article 42 of Decree Law No 825 now under the discussion, even if that proposal is not totally satisfactory for the industry, [since such a modification] could leave pisco in an even more disadvantageous position with respect to whisky.²⁸⁰

According to the same reports, the seminar was attended by Mr A. Gutiérrez Ortega, Under-Secretary of Agriculture.

4.574 The European Communities emphasizes that the reduction of the tax on whisky to 40%-45 % envisaged by the Government would have benefited not only whisky, but also all other spirits over 39°, including *pisco reservado* and *gran pisco*. The European Communities claims that the opposition of the pisco industry to that reduction constitutes additional proof that its overriding concern was to preserve a large tax differential between whisky and a large majority of pisco, even if that required "sacrificing" high strength pisco.

4.575 The European Communities also contends that, as soon as it became apparent that the 1995 Proposal would not be approved by Congress, the Government entered into negotiations with the pisco industry to try and agree on a new proposal that was (or, at least, appeared to be) less plainly inconsistent with Chile's obligations under the GATT. Those discussions led to the signature in September 1996 of a "protocol" by representatives of the Chilean Government and of the pisco industry. During the consultations with the European Communities, the Chilean Government described the contents of that protocol in the following terms:

The so-called protocol contains the summing up of the consultations held with the private sector as normally done in matters of public interest. It contains three distinct parts: the first simply reflects the acquiescence of the private sector with the Government's proposal to send a bill to Congress with the tax scale and transition period that later became law. The second and third part refer to other unrelated

²⁷⁸ See, e.g., the statements made by Representative Encina to *La Epoca*, 12 June 1996 (EC Exhibit 28); by Representative Pizarro to *El Diario*, 23 July 1996 (EC Exhibit 32) and *El Mercurio*, 24 July 1996 (EC Exhibit 33); and by Representative Munizaga (of the opposition party *Renovación Nacional*) to *Estrategia*, 31 July 1996 (EC Exhibit (36).

²⁷⁹ See *El Diario*, 31 July 1996 (EC Exhibit 34); *El Mercurio*, 31 July 1996 (EC Exhibit 35); *Estrategia*, 31 July 1996 (EC Exhibit 36); and *La Epoca*, 31 July 1996 (EC Exhibit 37).

²⁸⁰ *El Mercurio*, 30 June 1996 (EC Exhibit 29).

matters such as the agreement to initiate efforts at promoting exports of pisco through the governmental agency Pro - Chile.²⁸¹

4.576 The European Communities further argues that, despite its carefully chosen terms, this statement constitutes a recognition that the second proposal submitted by the Executive to Congress had been previously agreed with the pisco industry and, therefore, reflected the interests of that industry. According to the European Communities, the terms of that agreement were that in exchange for its acceptance of a marginal increase in the rate applied to *pisco corriente* and *pisco especial* and of a greater reduction of the tax rate on whisky than had originally been proposed (from 70 % to 47 %, instead of 50 %), the pisco industry would obtain financial "compensation" for the reduction of the level of protection.

4.577 According to the European Communities, in addition, the pisco industry would benefit from a long transitional period to adapt itself to the new situation. At the insistence of the pisco industry, that transitional period would apply not only with respect to the increase of the taxes in pisco but also with respect to the decrease of the taxes on whisky. The European Communities argues that this demonstrates, once again, that it was the reduction of the taxes on whisky, and not the increase of the taxes on pisco, which worried most the pisco industry.

4.578 The European Communities further claims that, following the signature of the protocol, the Chilean Government appears to have had second thoughts with respect to the WTO compatibility of the terms agreed with the pisco industry. Indeed, although the protocol was signed in September 1996, the Chilean Government failed to act upon it for nearly one year, which caused considerable alarm among the pisco producers.²⁸²

4.579 The European Communities argues that, following insistent calls by the pisco industry and the representatives of regions III and IV in Congress²⁸³, a new proposal embodying the terms of the protocol was eventually presented by the Government to Congress on 9 June 1997. This bill was approved by the Chamber of Deputies on 30 September 1997, and by the Senate (without debate) on 4 November 1997.

4.580 According to the European Communities, the minutes of the Chamber of Deputies' debate on 17 July 1997²⁸⁴ provide an extensive record of the objectives pursued by its proponents, among whom the representatives of regions III and IV figured very prominently. While declaring their support for the amendment, the representatives of those regions emphasised its negative impact for the pisco producers in their constituencies. The European Communities argues that, in doing so they were led to admit openly that pisco is directly competitive and substitutable with other distilled spirits (and in particular with whisky) and that the ILA had been effective in providing protection to the pisco industry.

4.581 The European Communities claims that the positions taken by the pisco industry during the amendment process of the ILA show that its overriding concern was to preserve a large tax differential between low strength pisco and whisky, even at the expense of increasing the tax on high strength pisco. According to the European Communities, this concern would have been totally irrational unless maintaining a tax differential between low strength pisco and whisky served to afford protection to the pisco industry.

²⁸¹ The European Communities notes that to the best of the EC's knowledge, the Chilean Government did not sign similar "protocols" with any other interested party of the "private sector", such as the importers of whisky.

²⁸² See *El Mercurio*, 10 April 1997 (EC Exhibit 45).

²⁸³ Ibid. See also *Las Ultimas Noticias*, 7 November 1996 (EC Exhibit 38); *La Segunda*, 12 February 1997 (EC Exhibit 41); and *El Diario*, 13 February 1997 (EC Exhibit 43).

²⁸⁴ Attached as EC Exhibit 16.

4.582 The European Communities goes on to state that the pisco industry requested that the 1995 Proposal be amended so that, between 35° and 42°, the tax rate increased by 6 percentage points per each additional degree of alcohol instead of by 5 percentage points. This request would have increased the rate on *pisco reservado* from 50 % to 55 % and the rate on *gran pisco* from 65 % to 73 %. The European Communities claims that, for the pisco industry it would have been senseless to make such a demand unless it had been convinced that increasing the tax on whisky would afford additional protection to the pisco industry as a whole.

4.583 The European Communities further states that later in the legislative process, the pisco industry opposed an amendment of the 1995 Proposal that would have lowered the tax rate on spirits above 39° to 40-45 % (instead of 50 %). This amendment would have benefited not only whisky and other imported spirits above 39°, but also *pisco reservado* and *gran pisco*. Again, according to the European Communities, the pisco industry's position would have been irrational unless it was premised on the conviction that, overall, a larger tax differential between low strength pisco and whisky would afford additional protection to pisco, despite the "sacrifice" of high strength pisco.

4.584 The European Communities also claims that according to the official reports of the Foreign Relations Committee of Chile's Chamber of Deputies, Capel and Control submitted two requests to that Chamber in the course of the parliamentary debate of the New Chilean System. Specifically, the Committee's reports read in relevant part as follows:

[Capel and Control] point out that in accordance with the wording of the draft, pisco is withdrawn as a taxed substance since the draft refers to spirits, in which category pisco is not included; the same holds for pisco which is excluded from the regulation as a specific concept.

They propose that the rate should vary by 6 % for each degree in alcohol instead of the 5 % proposed by the single article of the draft. They also suggest editorial changes to avoid confusion arising from vagueness in concepts used.²⁸⁵

4.585 In the view of the European Communities, in any event, a document provided by Chile in response to questions deals exclusively with the first of the two requests above mentioned. The reasons which led the pisco industry to demand an increase of the taxes on high strength pisco (the second of the above mentioned requests) still await an explanation by Chile. According to the European Communities, the only rational explanation for such an unusual demand is that the pisco industry was seeking to increase the tax differential between whisky and low strength pisco, which accounts for the vast majority of pisco sales.

4.586 **In rebuttal, Chile argues** that such points argued by the European Communities are simply an attempt to impugn the New Chilean System because, in Chile's democracy, a domestic industry seeks to have the tax or trade system be as favorable to it as possible, and the Chilean Government tried to obtain an understanding of a domestic industry that faced a wrenching change to the tax system that had been in effect for many years.

4.587 In the view of Chile, in the same vein, the European Communities devotes many pages listing excerpts from Chile's legislative debate about the new taxation system. Some of these examples show that legislative representatives of the regions that produce pisco in Chile were seeking to minimize the adverse effects of a New Chilean System on pisco producers and, because adverse effects could not be avoided, also sought other government help for their constituents. At least in the case of the legislative history, the European Communities, while presenting a distorted picture, did note many remarks from legislators who announced that the new system was eliminating discrimination against

²⁸⁵ See EC Exhibit 17, p.5.

foreign products. Chile submits that if such developments infringe Article III or are even evidence of such infringement, then all WTO Members are in deep peril, not least the European Communities.

4.588 Chile contends that the Memo No. 5886 was prepared in connection with the first bill submitted to Congress in November 1995, for amending the tax system on alcoholic beverages. As the Panel and the European Communities are aware, this bill was eventually replaced by the Government and some time later an amendment bill was introduced which eventually became actual Law No. 19.534. The memo is therefore completely irrelevant to this case. In addition, this Memo was originally an internal document prepared by a lawyer of Cooperativa Control for his General Manager, whereby he gives certain explanations about the system apparently used in the bill before Congress for taxing different alcoholic beverages, according to the definitions of the same contained in several Chilean Regulations.

4.589 Chile argues that it appears worth pointing out to the Panel, that any motivation the industry or other sectors in Chile may have had during the rather lengthy discussing process that eventually led to the inacting of Law 19,534, are at this stage completely irrelevant. It has already been ruled in GATT-WTO dispute settlement system, that panels should concentrate on the results and effects of the prevailing governmental measure or piece of legislation, and not on their possible aims. Such rulings are perfectly appropriate and understandable, even more in a Civil Law system, where the text of the law – particularly when it is crystal clear as in this case – will always prevail over any interpretation.

4.590 Chile reiterates that the issue before this Panel is not the objectives of the Chilean pisco industry (or those of the Scotch Whisky Association). It is curious that the European Communities, which laboured so hard in *Japan – Taxes on Alcoholic Beverages II* to discredit the "aims and effects" test, now seems to want to revive the test for private industry. Chile has no doubt that private industry associations want to do well by their private members, and be seen to have been successful on behalf of their members.

4.591 In the view of Chile, the issue is not the motive of the different private distillers of Chile or Scotland; both doubtless would like to make as much money as possible. That is not surprising, nor does it constitute a violation of the GATT. However, the issue before the Panel is whether the European Communities has demonstrated the three elements of a violation of Article III:2, second sentence.

4.592 Chile indicates that the Appellate Body has already cautioned against this kind of subjective effort to discern motivation. In *Japan - Taxes on Alcoholic Beverages II*, the Appellate Body stated that the issue of "affording protection to domestic production" is an objective question of *effect*, not a subjective question of the intent of legislators.²⁸⁶

4.593 Chile further argues that the European Communities likewise has not demonstrated that the New Chilean System operates so as to afford protection to domestic production. It is true that the result of the application of Chile's uniform, objective system of taxation may be that the majority of domestic distilled spirits will be taxed at a relatively low tax rate and the majority of imports will be taxed at a relatively high tax rate (if foreign producers or importers choose not to adapt their products in the simple manner required to benefit from the lowest tax category). However, that result does not constitute a violation of Article III:2. As to the EC's claims that the New Chilean System is GATT – illegal as evidenced by political statements and the ultimate acceptance of the pisco industry of the need for this change in Chile's law, such "evidence" has about the same value as a claim that the European Communities must be violating its obligations because politicians claim to have done well by domestic farmers or because EC farmers cease demonstrating after the European Communities

²⁸⁶ Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II*, *supra.*, pp. 27-28.

makes a change in farm policy. Finally, Chile has explained that there are multiple considerations behind the legislation, including significantly minimizing the regressive effects of a flat tax rate.

4.594 Chile also claims that it, in an attempt to avoid a burdensome and costly dispute settlement procedure and to address EU complaints, did not wait for a panel to decide on whether or not it ought to modify its legislation regarding its tax regime for alcoholic beverages. Chile after much consideration adopted a new final regime that Chile believes both fully complies with the GATT 1994 rules and provides immediate commercial benefit to the European Communities.

4.595 According to Chile, the Chilean legislature promulgated Law No. 19.534 on taxes on alcoholic beverages on 13 November 1997. This law provides a transitional period from 1997 to 2000 in order to permit a progressive and orderly change of the taxation regime applicable to alcoholic beverages in Chile. However, under the Old Chilean System whisky had been subject to a tax significantly higher than any other distilled spirit, which was the primary complaint of the European Union concerning the old law. To respond to those complaints, it was considered important to begin immediate phased reductions of the tax on whisky.

4.596 Chile states that it is worth recalling that the European Communities originally challenged in the WTO the Old Chilean System, which imposed taxes according to type of distilled spirits, with pisco taxed at 25%, whisky at 70% and all other spirits at 30%. Chile believed – and still does believe – that the old Chilean law was defensible because pisco is not directly competitive or substitutable with other distilled spirits in the Chilean market.

4.597 According to Chile, Chile amended its tax laws, in large part because of the complaints of the European Communities, especially in regard to whisky. In addition, the decision of the Appellate Body in the *Japan – Taxes on Alcoholic Beverages II* case suggested that, if the European Communities were able to show that pisco is directly competitive or substitutable with other distilled spirits, then a tax system that differentiated by type was likely to be found inconsistent with Article III:2.

4.598 In the view of Chile, pisco has not been shown to be directly competitive or substitutable with other distilled spirits. Nevertheless Chile enacted fundamental changes in this law.

4.599 Chile claims that in amending its laws, Chile had in mind several objectives, including:

- (i) maintaining fiscal revenue;
 - (ii) eliminating type distinctions such as those that had existed in Japan (which also would eliminate the alleged discrimination against whisky in the previous system);
 - (iii) discouraging alcohol consumption; and
 - (iv) minimizing the potential regressive aspects of reforming the tax system.
- (f) Low Import Duty on Alcoholic Beverages

4.600 **Chile claims** that a second point worth noting is that Chile is not protecting its industry as the European Communities claims. If that would have been the case Chile would have concentrated its "protectionist battery" on the tariff rate. A truly effective protectionist approach would have been to increase its applied tariff from 11 % up to 25 % (its own bound rate). Chile argues that it is moving in an opposite direction than that suggested by the European Communities: Chile is about to reducing its tariff to an a-cross-the-board rate of 6% (certainly including the most diverse spirits). Instead of protecting its producers, Chile is liberalizing unilaterally.

4.601 According to Chile, products of some countries like Mexico and Canada, face no duty because they have signed free trade agreement with Chile. The European Communities can also do the same if they decide to accept its invitation to begin negotiations for a free trade agreement early next year.

4.602 **In rebuttal, the European Communities claims** that this argument of Chile conceals the fact that since the 1970s Chile has applied a single flat rate to imports of all products. This is considered as one of the basic principles of Chile's trade policy. If the Chilean authorities were to make now an exception to that principle in favour of the pisco industry, it would be difficult for them to resist similar requests from other domestic industries.

4.603 The European Communities further notes that, as noted by Chile itself, two of the main producers of spirits (Mexico and Canada) have already concluded Free Trade Agreements ("FTAs") with Chile, while the EC Commission has formally proposed to the EC Council the opening of negotiations with Chile for the conclusion of an Association agreement comprising the establishment of an FTA. Similarly, the US Executive has requested fast-track authority to negotiate a FTA with Chile. It is clear, therefore, that in the long term tariffs could not afford to Chile's pisco industry the desired level of protection. In fact, the perspective of concluding an FTA with the European Communities was precisely one of the reasons invoked by the pisco industry during the process of adoption of the New Chilean System in order to justify its request for limiting the reduction of the taxes on whisky.²⁸⁷

V. THIRD-PARTY ARGUMENTS

A. CANADA

1. Introduction

5.1 Canada indicates that it has a substantial interest in this dispute. According to Canada, Chile's tax regime imposes a much higher tax burden on imported distilled spirits than that imposed on the directly competitive or substitutable domestic distilled spirit, pisco. The taxes afford protection to the domestic pisco industry by denying imported distilled spirits, including Canadian whisky, the competitive opportunities available to pisco. This has an adverse impact on the ability of Canadian distilled spirits to compete effectively with pisco; this situation discourages efforts by Canadian exporters, and thus serves to frustrate penetration of the Chilean market. Canada restates that it was a complainant in the *Japan - Taxes on Alcoholic Beverages II*²⁸⁸ case, and as a consequence, has an active interest in the legal issues which arise from a very similar dispute.

5.2 Canada has reviewed the submissions of the European Communities and Chile, and supports the EC position in this proceeding.

2. Legal Arguments

5.3 Canada welcomed the outcome of the *Japan - Taxes on Alcoholic Beverages II* case and was pleased with the principles set out by the Appellate Body for the interpretation and application of Article III:2 of GATT 1994. Canada notes that the issues which arise in the context of the Chilean liquor tax regime bear strong resemblance to matters which were under dispute in *Japan - Taxes on Alcoholic Beverages II*²⁸⁹, and accordingly, the panel's disposition of the present dispute should be

²⁸⁷ See EC Exhibit 30.

²⁸⁸ Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II*, *supra*.

²⁸⁹ *Ibid.*, p. 27 [*sic*], in which the Appellate Body set out the issues:

guided by the principles established in the panel and Appellate Body Reports²⁹⁰ in that case. These principles were followed recently in a panel decision in another dispute, *Korea - Taxes on Alcoholic Beverages*.²⁹¹

(a) "directly competitive or substitutable"

5.4 Canada notes that the European Communities correctly points out that Article III:2, second sentence, applies not only to products that are actually competitive or substitutable in a particular market, but also to those that are potentially competitive or substitutable.²⁹² However, in Canada's view this should not be a central issue in this dispute.

5.5 Canada believes that the European Communities has adduced conclusive evidence of existing competition between pisco and imported distilled spirits in the Chilean market.²⁹³ The reaction of the pisco industry in Chile to proposed reductions in the taxes on whisky (and increases in taxes on pisco) provides compelling evidence for the panel to deduce that there is direct competition between pisco and imported distilled spirits.

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

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

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

²⁹⁰Panel Report on *India - Patent Protection for Pharmaceutical and Agricultural Chemical Products*, adopted on 2 September 1998, WT/DS79/R, para. 7.30, the panel indicated that panels:

....should give significant weight to both Article 3.2 of the DSU, which stresses the role of the WTO dispute settlement system in providing security and predictability to the multilateral trading system, and to the need to avoid inconsistent rulings.

²⁹¹Panel Report on *Korea - Taxes on Alcoholic Beverages*, *supra*.

²⁹²Canada states that imported products that may only be potentially competitive with a domestic product should not be categorically excluded from the scope of Article III:2, second sentence. Otherwise, internal regulatory regimes that favour domestic production to such an extent that imported products are effectively barred from entering the domestic market could be rendered beyond challenge.

²⁹³According to Canada, the products at issue share similar physical characteristics, the same end-uses, the same HS heading, the same sales outlets, and even share the same shelf space (see, for example, subsections IV.D.3-6 of the EC's first written submission). There is also evidence of significant cross-price elasticity and elasticity of substitution (see, for example, subsection IV.D.7. of the EC's first written submission). Of course the ultimate corroboration for this view is that both Chilean authorities and the pisco industry have expressly and implicitly recognized that pisco and other distilled spirits are directly competitive and substitutable (See, for example, subsection IV.D.8 of the EC's first written submission).

5.6 With respect to potential competition, Canada notes that the Appellate Body in *Japan – Taxes on Alcoholic Beverages II* held that GATT Article III:

[p]rotects potential competition ... of the equal competitive relationship between imported and domestic products.²⁹⁴

5.7 Also in connection with the issue of potential competition, Canada supports the arguments made by the European Communities, and submits that the reasoning of the panel in *Korea - Taxes on Alcoholic Beverages*²⁹⁵ is compelling for the resolution of the present dispute.

5.8 Moreover, the imported products, such as Canadian whisky, unquestionably fall within the meaning of "substitutable" products. From Canada's perspective, it is particularly noteworthy that Chilean whisky and pisco drinkers "each prefer the other spirit as a first alternative".²⁹⁶ Thus, it is submitted that the products at issue are both directly competitive and substitutable.

(b) "not similarly taxed"

5.9 In Canada's view, there is no doubt that pisco and the imported spirits are not similarly taxed. The Panel should reject Chile's attempt to divert attention away from the fundamental question of whether this particular measure in this particular set of circumstances constitutes dissimilar taxation. All aspects of the measure, from its transitional phase through to its final form, involve more than a *de minimis* differential in the taxation of directly competitive or substitutable products.

5.10 For example, under the transitional phase whisky is currently taxed at 65% *ad valorem*, while pisco is taxed at only 25% *ad valorem*. Although the rate for whisky will be reduced over the next few years, the lowest rate it will achieve during the transition phase is 53%, while pisco remains at 25%. It is indisputable that this constitutes dissimilar taxation.

5.11 Canada further argues that, even in its final form (i.e., the "New Chilean System") the measure taxes the products dissimilarly. Chile appears to take the position that the products are taxed similarly because the differences in taxation correspond to differences in alcohol content. Such an argument is untenable for several reasons. First, the measure is not purely a tax on alcohol content. The tax is calculated on the value of the beverage as a whole. Second, if it were purely a tax on alcohol content one would expect a uniform rate per degree of alcohol. However, the rate per degree of alcohol for pisco at 35° is 0.771%, while whisky at 40° is taxed at 1.175% per degree of alcohol, a level which is 50% higher. Third, if it were purely a tax on alcohol content one would not expect the same rate of tax to be applied to beverages with different alcohol strengths. However, the tax rate for whisky at 40° (47% *ad valorem*) is the same as that applicable to gran pisco at 50°, despite the ten degree difference in alcohol content.²⁹⁷

5.12 Canada states that in any event, the measure is a tax on the value of the beverage, not the value of that which is purportedly being taxed - alcohol content. Viewed from this perspective, the tax of 47% of the value of a bottle of whisky at 40° alcohol content, is dissimilar to the 27% *ad valorem* tax on a directly competitive or substitutable bottle of pisco with 35° alcohol content.²⁹⁸

²⁹⁴ Appellate Body Report on *Japan – Taxes on Alcoholic Beverages II*, *supra.*, p. 16.

²⁹⁵ Panel Report on *Korea - Taxes on Alcoholic Beverages*, *supra.*, paras. 10.47 - 10.50.

²⁹⁶ 1997 SM survey (referenced at para. 130, and EC Exhibit 21 at page iv).

²⁹⁷ The measure provides that the tax rate applicable to spirits with an alcohol content over 39° is 47%.

See paragraph 52 and Table 5 of the EC's first written submission.

²⁹⁸ Canada points out, that as noted by the EC (at paragraph 173 of EC First Submission), such a tax differential is greater than *de minimis*.

5.13 In short, according to Canada, Chile is attempting to hide a discriminatory regime behind the facade of a purportedly "objective" product difference. However, dissimilar taxation is evident irrespective of whether the tax is viewed as tied to the value of the beverage, or to alcohol content. If Chile's transitional and new tax regimes on spirits are accepted by the Panel, this would provide WTO Members with a blueprint for circumventing their Article III:2 second sentence obligation simply by establishing spurious product categories. The Chilean regime is a thinly disguised discriminatory measure that maintains the protection of the domestic pisco industry. If this regime were to be found consistent with GATT Article III:2, other Members may be tempted to implement similar regimes in order to protect domestic production, with the ultimate effect that Article III could be seriously undermined.

5.14 Canada concludes, that the Chilean argument that there is no jurisprudence establishing that taxes must be proportional, should not cloud the issue whether Chile's taxes are dissimilar. In Canada's view, an examination of the taxation rate per degree of alcohol or of the taxation rate per bottle, demonstrates that the taxes applicable to the majority of domestic pisco are not similar to the taxes for the majority of the directly competitive or substitutable imported distilled spirits.

(c) "so as to afford protection"

5.15 Canada recognises that an *ad valorem* tax is not inherently inconsistent with Article III:2, second sentence. Rather, it is the manner in which Chile is applying this particular *ad valorem* tax that is contrary to Article III:2, second sentence. As previous panels have found, and the Appellate Body has affirmed:

Article III:2 does not prescribe the use of any specific method or system of taxation. ... Since Article III:2 prohibited only discriminatory or protective tax burdens on imported products, what mattered was, in the view of the Panel, whether the application of the different taxation methods actually had a discriminatory or protective effect against imported products.²⁹⁹

5.16 Canada argues that several aspects of the design, architecture and structure of Chile's tax regime establish its protective application. First, the sheer magnitude of the tax rate differential in this case is sufficient to establish that the measure is applied so as to afford protection to the domestic pisco industry in Chile. Second, the measure's structure ensures that the vast majority of Chile's production of distilled spirits (primarily pisco) will continue to be eligible for the lowest possible tax rate (27%), while almost all imported distilled spirits will continue to be taxed at the highest rate (47%). Protection for pisco is further ensured by legislation requiring certain imported distilled spirits (notably those that appear to be most competitive with and substitutable for pisco, such as whisky) to have a minimum alcohol strength of 40°. As applied, the tax rates would create a wide, protective buffer zone for domestic pisco in relation to imported distilled spirits.

5.17 Canada argues that the combination of these and the other factors identified by the European Communities is to deny imported distilled spirits the competitive opportunities available to Chilean pisco. Canada notes that, similar to the situation in *Japan – Taxes on Alcoholic Beverages II*,³⁰⁰ the

²⁹⁹ Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II*, *supra.*, p. 32 [*sic*], citing the Panel Report on *Japan – Taxes on Alcoholic Beverages I*, *supra.*, para. 5.9 c).

³⁰⁰ *Ibid.*, p. 34 [*sic*], where the Appellate Body, in discussing the protective application of the measure, quotes paragraph 6.35 of the Panel Report as follows:

[W]e conclude that [the panel] reasoned correctly that in this case, the Liquor Tax Law is not in compliance with Article III:2. As the Panel did, we note that:

[t]he combination of customs duties and internal taxation in Japan has the following impact: on the one hand, it makes it difficult for foreign-produced shochu to penetrate the Japanese

Chilean measure fails to guarantee equality of competitive conditions between the imported and domestic products, and makes it difficult for imported distilled spirits to penetrate the Chilean market. In effect, it "isolates" pisco from foreign competition by imported distilled spirits.

5.18 Canada notes, that while the European Communities correctly challenges the absence of a legitimate policy purpose, it is important that its assertion not be interpreted to suggest that the existence of such a purpose would make the regime consistent with Article III:2. The fact that a measure may have a non-protectionist policy objective does not make that measure consistent with Article III:2, second sentence.³⁰¹ As noted by the Appellate Body in *Japan – Taxes on Alcoholic Beverages II* :

If the measure is applied to imported or domestic products so as to afford protection to domestic production, then it does not matter that there may not have been any desire to engage in protectionism in the minds of the legislators or the regulators who imposed the measure. It is irrelevant that protectionism was not an intended objective if the particular tax measure in question is nevertheless, to echo Article III:1, "*applied to imported or domestic products so as to afford protection to domestic production*".³⁰²

5.19 Canada further notes that it is equally important to remember that the Appellate Body has made it clear that it is not necessary to provide evidence of protectionist intent in order to prove that a measure affords protection to domestic production.³⁰³ However, this does not mean that the statements of Chilean officials and the Chilean pisco industry are irrelevant. Their statements regarding the need and means to protect the pisco industry help to confirm the protective design, architecture and structure of the measure.

5.20 Canada argues that, in any event, claims about the protection of public health are not supported by the facts. Such claims can only be viewed as *ex post facto* justification, in the light of statements by Chilean officials and pisco industry representatives, to the effect that the taxation regime is designed to protect the pisco industry from competition by imported distilled spirits.

5.21 Canada stresses that Chile cannot justify the dissimilar taxes on the basis that certain Chilean products may be subject to the higher tax rates, while certain imported products may benefit from the lower tax rates. There is nothing in Article III:2, nor any of the GATT or WTO panel or Appellate Body reports, that can be used to justify a taxation measure that benefits the majority of a domestic industry's production, and places the majority of the directly competitive or substitutable products at a competitive disadvantage to the domestic products. To the contrary, following the reasoning of the Appellate Body in the *Japan – Taxes on Alcoholic Beverages II* case, if there is dissimilar taxation of

market and, on the other, it does not guarantee equality of competitive conditions between shochu and the rest of 'white' and 'brown' spirits. Thus, through a combination of high import duties and differentiated internal taxes, Japan manages to "isolate" domestically produced shochu from foreign competition ...

³⁰¹ Canada notes that if a WTO Member wants to maintain a measure that is inconsistent with Article III:2, it must meet the conditions set out in GATT Article XX.

³⁰² Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II*, *supra.*, p. 31 [*sic*].

³⁰³ In *Japan - Taxes on Alcoholic Beverages II*, *supra.*, p. 31), in describing what must be shown in order to establish that a tax is "protective", the Appellate Body stated:

This is not an issue of intent. It is not necessary for a panel to sort through the many reasons legislators and regulators often have for what they do and weigh the relative significance of those reasons to establish legislative or regulatory intent.

some imported products in comparison with directly competitive or substitutable domestic products, this is sufficient to meet the test of "not similarly taxed".³⁰⁴

5.22 Canada concludes that Chile misconstrues the concept of equality of competitive opportunities, by suggesting that foreign producers can adapt their production to benefit from lower taxes. In Canada's view, the converse is true, i.e. if foreign producers must adapt their production and thereby lose the value of their product name in order to benefit from the lower tax, their imported products would be at a competitive disadvantage to the vast majority of pisco, which would not have to meet these burdens.

B. MEXICO

1. Introduction

5.23 Mexico does not agree with Chile that the Transitional System is not at issue in this dispute. On the contrary, Mexico considers that since the system has been incorporated into the transitional period, it corresponds to "the matter referred to the DSB", and that the Panel must determine whether the two systems i.e. the Transitional and New Chilean Systems are inconsistent with Article III.2 of the GATT 1994.

5.24 As mentioned by the European communities in their submission, the products at issue are, on the one hand, pisco, and, on the other hand, all the other distilled spirits falling within the heading HS 22:08 of the Harmonized System (HS) nomenclature. The European Communities provided an illustrative list of these products, expressly including tequila.

5.25 Mexico insists that tequila and pisco are "like products" in the sense of Article III.2, first sentence, of the GATT 1994, but is merely requesting the Panel to find that tequila and pisco are directly competitive or substitutable products³⁰⁵ in the sense of Article III.2, second sentence, of the GATT 1994.

5.26 In this connection, Mexico agrees with the parties to the dispute in their endorsement of the conclusions of the Appellate Body in *Japan – Taxes on Alcoholic Beverages II*³⁰⁶ according to which the following rules must be applied to determine the inconsistency of an internal tax measure with Article III.2, second sentence:

- (i) The imported products and the domestic products must be "directly competitive or substitutable products" which are in competition with each other;
- (ii) the directly competitive or substitutable imported and domestic products must not be "similarly taxed"; and

³⁰⁴Ibid., p. 27. Moreover, it is noteworthy that in *United States - Section 337*, the panel found: ... that the "no less favourable" treatment requirement of Article III:4 has to be understood as applicable to each individual case of imported products. The Panel rejected any notion of balancing more favourable treatment of some imported products against less favourable treatment of other imported products.

Panel Report on *United States – Section 337*, *supra.*, para. 5.14.

³⁰⁵Panel Report on *Korea – Taxes on Alcoholic Beverages*, *supra.*, para. 10.38, agrees with the statement by the Appellate Body in *Japan – Taxes on Alcoholic Beverages II*, *supra.*, that the category of "directly competitive or substitutable products" is broad.

³⁰⁶Appellate Body Report *Japan - Taxes on Alcoholic Beverages II*, *supra.*, p. 24.

- (iii) the dissimilar taxation of the directly competitive or substitutable imported and domestic products must be applied "... so as to afford protection to domestic production".

2. Legal Arguments

- (a) "directly competitive or substitutable"

5.27 In order to determine which products belong to this category, the following criteria should be applied³⁰⁷:

- (i) Physical characteristics;
- (ii) common end-uses;
- (iii) tariff classification;
- (iv) the "market-place".

(i) *Physical Characteristics*

5.28 Mexico disagrees with Chile's assertion that the products under consideration have virtually no characteristics in common. The two characteristics mentioned in the Panel Report on *Korea – Taxes on Alcoholic Beverages*³⁰⁸ are fully applicable to the comparison between pisco and tequila as well: they are both distilled spirits, bottled and labelled in a similar manner.

5.29 Mexico notes that the Panel Report on *Japan – Taxes on Alcoholic Beverages II* states that the physical characteristics are not the decisive criterion for determining whether products are competitive or substitutable.³⁰⁹ However, Mexico agrees with the European Communities when it asserts that "if two products have sufficiently similar physical characteristics, such similarity may of itself be sufficient to conclude that the products in question are apt to serve for the same end-uses".³¹⁰

(ii) *End-uses*

5.30 Mexico notes that the European Communities, in their submission, refers to the findings of the Panel in *Japan – Taxes on Alcoholic Beverages II* according to which the end-uses are the "decisive criterion" for establishing whether two products are directly competitive or substitutable.

5.31 Mexico further notes that the 1997 SM Survey³¹¹ shows that tequila and pisco have the same end-uses in at least the following respects:

- (i) drinking styles: both spirits are most likely to be consumed with a mixer beverage (such as cola);
- (ii) drinking occasions: Chilean consumers of spirits considered "parties", "with friends", "family meetings" and "weekends" to be the most common occasions for the

³⁰⁷These criteria were established by the panel and adopted by the Appellate Body in *Japan - Taxes on Alcoholic Beverages II*, *supra.*, p. 25.

³⁰⁸Panel Report on *Korea – Taxes on Alcoholic Beverages*, para. 10.67.

³⁰⁹Panel Report on *Japan – Taxes on Alcoholic Beverages II*, para. 6.22.

³¹⁰See EC First submission, para. 109.

³¹¹See EC Exhibit 21.

consumption of pisco or tequila, while the categories "after work", "aperitif", "during week" and "digestive" were considered less common;

- (iii) drinking places: both spirits are mainly consumed "at home" or at a "friend's house";
- (iv) availability in sales channels: the most common sales channels for both beverages are "supermarkets" and "liquor stores", while "gift shops", "duty-free", "others" and "airlines" are uncommon as sales channels in both cases; and
- (v) types of consumers: in the Chilean market, women tend to drink more pisco and/or tequila than men.

5.32 Furthermore, the recipe brochures mentioned by the European Communities³¹² suggest that the producers of pisco themselves perceive pisco and tequila as products with a common final use, i.e. the preparation of "margaritas".

(iii) *Tariff Classification*

5.33 Mexico notes that both beverages come under HS subheading 2208.90, i.e. they are at the same six-digit level, which is the Harmonized System's most advanced and specific classification. In Mexico's view, it is also worth noting that the Appellate Body in *Japan – Taxes on Alcoholic Beverages II* pointed out that if "sufficiently detailed, tariff classification can be a helpful sign of product similarity".³¹³

5.34 Regarding the mutual substitutability of tequila and pisco in the Chilean market, Mexico refers to the EC's Exhibit 22, Table 4.1.2, which purportedly shows that 17 per cent of consumers of Chilean spirits would buy tequila if they intended to buy pisco and did not find it, while 56 per cent would buy pisco if they could not find tequila.

5.35 As regards cross-price elasticity, the analysis submitted by the European Communities³¹⁴ shows a 44.8 per cent change in response to a 27 per cent tax on all spirits instead of the tax currently applied. The table shows a considerable price elasticity.

(iv) *Recognition of Government of Chile*

5.36 Mexico points out that in addition to the evidence presented by Mexico, it should be noted that Chile implicitly accepted that pisco and the other spirits at issue in this case are directly competitive or substitutable. More specifically, Chile states that the examples provided by the European Communities concerning the background to the new law "show that legislative representatives of the regions that produce pisco in Chile were seeking to minimize the adverse effects of a New Chilean System on pisco producers and, because adverse effects could not be avoided, also sought other government help for their constituents".³¹⁵ Mexico asks rhetorically, what adverse effects would the new system have if the products were not "directly competitive or substitutable"?

³¹²See EC First submission, para. 140.

³¹³Appellate Body Report on *Japan – Taxes on Alcoholic Beverages II*, *supra.*, p. 21. Various panels shared that opinion, such as *EEC – Measures on Animal Feed Proteins*, *supra.*, *Japan – Taxes on Alcoholic Beverages I*, *supra.*, and *United States – Standards for Reformulated and Conventional Gasoline*, *supra.*

³¹⁴See Table 4.2.2, EC Exhibit 22.

³¹⁵See Chile First submission, para. 71.

(b) "not similarly taxed"

5.37 As can be seen in Table I of Mexico's submission, the tax differentials show a margin of discrimination of 120 per cent and 174.4 per cent between pisco and tequila under the "Old Chilean System" and the "New Chilean System" respectively.

5.38 Moreover, Mexico agrees with the panel and the Appellate Body in *Japan – Taxes on Alcoholic Beverages II* when they argue that the amount of differential taxation must be more than *de minimis*, as determined on a case-by-case basis.³¹⁶ In the case at issue, the differentials in the rate of taxation suffice to establish that they are in excess of any *de minimis* criterion.

(c) "so as to afford protection"

5.39 Mexico notes that the panel in *Korea – Taxes on Alcoholic Beverages*³¹⁷ endorses the conclusion of the Appellate Body in *Japan – Taxes on Alcoholic Beverages II*, focussing on the objective factors underlying the tax measure in question including its design, architecture and the revealing structure.

5.40 In the case at issue, the following elements show that Chile imposed its tax scheme in order to afford protection to its domestic industry:

- (i) the amount of the differential taxation (see Table I);
- (ii) the structure of the Chilean tax system;
- (iii) the fact that the great majority of distilled spirits produced on the Chilean market have an alcohol strength of 35° or less;
- (iv) the fact that most imported distilled spirits have an alcohol strength of more than 35° and, in many cases, more than 39°.

5.41 Mexico notes that as regards design, architecture and the revealing structure of the measure, Chile accepted that its new system was "biased" against relatively higher alcohol products. Chile denied however, that this was a means of affording protection to domestic production³¹⁸ on the grounds that the producers of other spirits could benefit from the system by diluting their products with water or switching their exports to beverages benefiting from a lower level of taxation.³¹⁹

5.42 According to Mexico, Chile's proposals are obviously not only unworkable, but also irrelevant. The product that Mexico is interested in exporting to Chile is tequila. Apart from the fact that under Chilean law, tequila must have a minimum alcohol strength of 40°³²⁰, and that it must comply with the corresponding Mexican Official Standard to be marketed under that name, it is obvious that the consumer of tequila wants tequila and not water. Mexico points out that if its intention had been to export spirits with a strength of 35° or less, it would not have bothered to participate as a third-party in this dispute. In Mexico's view, these arguments by Chile simply confirm that the protection afforded to national production is so high that the only way of competing

³¹⁶Appellate Body Report on *Japan – Taxes on Alcoholic Beverages II*, *supra.*, p. 27. This same argument was used by the Panel in *Korea – Taxes on Alcoholic Beverages*, *supra.*, para. 10.100.

³¹⁷Panel Report on *Korea – Taxes on Alcoholic Beverages*, para. 10.101.

³¹⁸Chile First submission, para. 68.

³¹⁹*Ibid.*, para. 73.

³²⁰*See* Article 12 of the Regulation Implementing Law No. 18455, published in the Official Journal of 23 October 1986 and appearing as Appendix 2.2 of EC Exhibit 12.

on an equal footing with Chilean beverages would be to change the quality of the imported products or the products themselves.

5.43 Mexico further notes that Chile agrees with the European Communities that in its system, different levels of alcohol strength are taxed differently, but argues that Article III:2 of the GATT 1994 has never been interpreted to require a direct proportionality rule. It points out that the Panel in *Japan – Taxes on Alcoholic Beverages I*, only suggested that taxation must be based on objective criteria. The Chilean system of taxation is not, nor can it be considered to be, based on "objective criteria". Chile gives no satisfactory explanation of how a margin of discrimination of 174.07 per cent³²¹ applied to the difference of little more than 4° in alcohol strength under the Chilean tax structure (between 35° and 39°) can be seen as being based on "objective criteria". Mexico is not challenging the fact that the Chilean tax varies according to the alcohol strength of the beverages: it is challenging the way in which that tax is applied. Mexico further argues that, the purpose and effect of the Chilean system is to protect national production against imports of products that are directly competitive with or substitutable for Chilean beverages.

5.44 Mexico argues that in considering the fact that the national production of spirits in Chile is dominated by pisco with an alcohol strength of 35° or less, it is interesting to refer to Table II below. Mexico points out this table was prepared on the basis of Table 8 which forms part of Annex III of Chile's written submission, and shows, in terms of volume, the share of pisco with a strength of 30° and 35° in the Chilean market. Moreover, according to the European Communities, with the exception of 1992, the share of pisco in the Chilean spirits market grew constantly from 44.1 per cent in 1982 to 73.8 per cent in 1996.

5.45 Mexico notes that Chile, in its own written submission,³²² reveals the substantial share of imports of spirits with a strength of 40° or more in the Chilean market. It should be observed that tequila is not expressly mentioned³²³, so that the percentage shares are in fact higher than those shown.³²⁴

5.46 Mexico further notes that according to the European Communities, imports of whisky and tequila (the two most popular beverages after pisco) account for 93.6 per cent and 100 per cent respectively of the Chilean market for those spirits.³²⁵ It is curious that under the New Chilean System, these two products are taxed the most heavily; and, the tax applied to tequila will now increase from 30 per cent to 47 per cent. This in itself should be sufficient evidence that the Chilean system is designed to protect domestic production.

5.47 Mexico concludes that it has proved that the Chilean tax system is contrary to the provisions of Article III.2, second sentence, of the GATT 1994, and therefore requests that the Panel:

- (a) find that the Chilean system for the taxation of spirits violates the second sentence of Article III.2 of the GATT 1994 in order to help the DSB in making the recommendations or issuing the resolutions provided for under the GATT 1994;
- (b) find that the measure at issue nullifies or impairs benefits under the GATT 1994 by favouring pisco in a manner contrary to that Agreement.

³²¹ See Table I.

³²² Ibid., Annex III, Tables 1-7.

³²³ The table provided by Chile only mentions the following spirits as having a strength of 40° or more: whisky, rum and other white spirits, gin and geneva, and, for 1996 and 1997, vodka as well.

³²⁴ See Table III.

³²⁵ Tables 9.A and 9.B of EC First submission, p. 36

Table I

Margins of Discrimination

	Pisco	Tequila	Margin of discrimination
Tax applied under the "old system"	25%	30%	120%
Tax applied under the "new system"	27%	47%	174.07%

Table II

Share of Pisco with a Strength of 35° or Less in the Chilean Spirits Market

	1991	1992	1993	1994	1995
Pisco 30°	64.51%	60.50%	52.29%	41.57%	33.53%
Pisco 35°	5.27%	8.45%	17.56%	26.69%	35.57%
Total of the two piscos	69.78%	68.95%	69.85%	68.26%	69.10%

Table III

Market Share of Spirits with a Minimum Strength of 40°

	1991	1992	1993	1994	1995	1996	1997
Volume	82.65%	81.31%	76.37%	66.81%	60.00%	50.83%	54.37%
Value	86.57%	84.69%	79.38%	78.02%	71.09%	59.5%	59.63%

C. PERU

5.48 Peru briefly stated that it considers that the Chilean system of taxation of alcoholic beverages is discriminatory, contrary to Article III:2 of GATT 1994, and causes harm to Peruvian exports of alcoholic beverages to Chile.

5.49 Peru also referred to an issue it has raised in two DSB meetings, regarding the propriety of the use of the term pisco by Chile.³²⁶ Peru stated that it was an exporter of pisco to Chile and since the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) would only enter into force in Chile and Peru in the year 2000, Peru wished to reserve its rights to invoke Article 22.1 of the TRIPS Agreement and other provisions related thereto. Peru considered that the geographical indication "Pisco" was Peruvian and as such gave Peru exclusive rights.

³²⁶ Peru has previously expressed its position at two DSB meetings on 18 November 1997, and 25 March 1998 (see WT/DSB/M38 & WT/DSB/M/44).

D. UNITED STATES

1. Introduction

5.50 The United States asserts that Latin America is a key growth market for its distilled spirits producers, who have undertaken significant efforts to promote U.S. products in the region. U.S. exports of distilled spirits to Peru and Venezuela have grown by 52% and 116% respectively over the past two years, following the elimination of discriminatory measures.³²⁷ However, despite significant economic growth in Chile, U.S. distilled spirits exports have not witnessed similar growth, due to Chile's history of discriminatory taxation.

5.51 The United States further asserts that in 1996, it exported approximately \$1.1 million in distilled spirits to Chile.³²⁸ Whiskey, which includes Bourbon and Tennessee whiskey, two distinctive types of American whiskeys produced from fermented grains, accounted for 29.7% of the total U.S. exports of the distilled spirits at issue in this dispute.³²⁹ Other traditional spirits at issue are rum, gin and vodka, which accounted for 61.4% of these exports. The remaining 9% of U.S. exports to Chile include liqueurs (3.3%) and pre-mixed cocktails.³³⁰

5.52 The facts developed by the European Communities conform to the experience of the U.S. exporting industry. Chile's measures at issue consist of two elements: (1) the current Transitional System, which applies different tax rates for particular product categories, and (2) the New Chilean System, which will tax on the basis of alcohol content (through Law 19.534, an amendment to its Decree-Law 825/1974).

5.53 As a legal matter, the United States considers that:

- (i) The Transitional System on distilled spirits, applicable until 30 November 2000, is inconsistent with the second sentence of Article III:2 of GATT 1994 because it provides for lower internal taxes on the domestic spirit "pisco" than on directly competitive or substitutable imported spirits falling into the tax categories of "whisky" and "other spirits", and is applied so as to afford protection to Chile's domestic production of pisco; and
- (ii) The New Chilean System on distilled spirits, applicable as of 1 December 2000, is inconsistent with the second sentence of Article III:2 of GATT 1994 because it results in the imposition of lower taxes on domestic spirits with an alcohol content of 35 degrees or less than on directly competitive or substitutable imported spirits that have a higher alcohol content, and is applied so as to afford protection to Chile's domestic production.

³²⁷ According to the United States, in June 1993 Peru replaced its discriminatory selective consumption tax (10% for pisco and 50% for other spirits) with a single ad valorem tax of 10%. Similarly, Venezuela presently assesses a rate of Bs.10 per liter for all alcoholic beverages.

³²⁸ See U.S. Exhibit 1, the 1996 data on U.S. distilled spirits exports to Chile (by class). The 1996 data are the most recent and most complete available.

³²⁹ See 27 CFR Sec. 5.21.

³³⁰ The United States notes that the majority of the 5.7% of the "other" category in U.S. Exhibit 1 consists of ethyl alcohol, a product used for industrial purposes and as a primary input for the production of other distilled spirits; ethyl alcohol is not at issue in this dispute. A *de minimis* portion of the "other" category includes pre-mixed cocktails.

2. Legal Arguments

(a) General

5.54 As the European Communities notes in its submission, the Appellate Body has clarified the interpretation of Article III:2, second sentence in *Japan - Taxes on Alcoholic Beverages II*. The Appellate Body stated that in order to find an internal tax measure inconsistent with the second sentence of Article III:2, three separate elements must be satisfied:

- (i) the imported products and the domestic products must be "directly competitive or substitutable products" which are in competition with each other;
- (ii) the directly competitive or substitutable imported and domestic products must be "not similarly taxed"; and
- (iii) the dissimilar taxation of the directly competitive or substitutable imported domestic products must be "applied ... so as to afford protection to domestic production",³³¹ which requires an examination of "the underlying criteria used in a particular tax measure, its structure, and its overall application..."³³² These underlying criteria include the "design, the architecture, and the revealing structure of a measure", the "magnitude of the dissimilar taxation", and "all the relevant facts and all the relevant circumstances in any given case".³³³

5.55 The United States notes that, with respect to the first element -- whether two products are "directly competitive or substitutable" -- the European Communities argues convincingly that all types of pisco, regardless of alcohol content, are the same product; that pisco and all other distilled spirits share the same basic physical characteristics; that pisco and all other distilled spirits have the same end-uses; that pisco and all other distilled spirits fall within the same HS heading, HS 22.08; that pisco and all other distilled spirits are sold in the same sales channels; and that there is significant cross-price elasticity between pisco and the all other distilled spirits. In fact, the European Communities establishes that not only is there a close competitive relationship between imported spirits and domestic pisco, but that all distilled spirits at issue are directly competitive or substitutable with each other.

5.56 According to the United States, there is also ample evidence that both the Transitional System and the New Chilean System involve dissimilar tax treatment as between domestic and imported products, and afford protection to domestic production.

(b) Old Chilean System: Background

5.57 The United States argues that an examination of the tax system immediately preceding the present Transitional System helps to show the protective structure of both the present regime and the regime to take effect in the year 2000. The EC's account of the debate in the Chilean government concerning the Old Chilean System and the process of adopting the Transitional System and the New Chilean System demonstrates that protectionist forces prevailed in their effort to ensure that the new

³³¹ Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II*, supra. The three elements approach was most recently used in the Panel Report on *Korea - Taxes on Alcoholic Beverages*, supra, paras. 10.34-10.102.

³³² Ibid., p. 29.

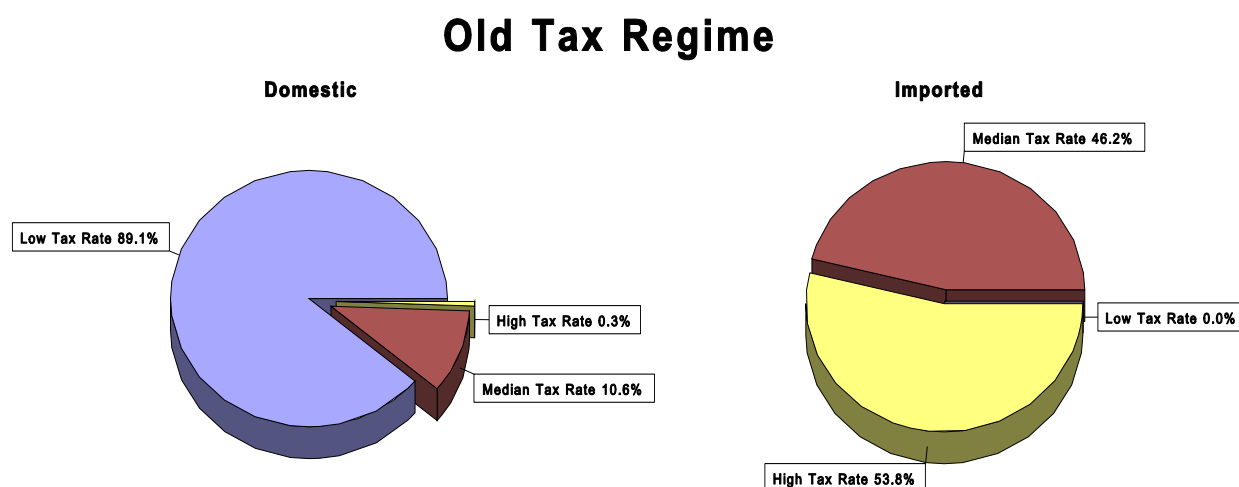
³³³ Ibid., p. 29.

systems would create the same protective effect as the Old Chilean System they were introduced to replace.³³⁴

5.58 The "Old" Chilean System, established by Decree-Law 825/1974, was in effect from June 1979 to 30 November 1997. It explicitly classified all distilled spirits into three particular product categories: pisco, whisky, and "other spirits". Prior to its termination it applied an *ad valorem* tax rate of 25% to pisco, 70% to whisky, and 30% to all other spirits.³³⁵

5.59 According to the United States, the Old Chilean System taxed imports and domestic products in a dissimilar fashion, thus satisfying the second element of the Appellate Body's approach to the second sentence of Article III:2. The magnitude of the difference between the rates for whisky and pisco speaks for itself; the 5% differential in the tax rates applied to pisco and other imported distilled spirits is also beyond *de minimis*. Given the tight competition between distilled spirits, for example those that are used with mixers (e.g., pisco and Puerto Rican rum), even a small variation in price such as a 5% difference in taxation can sufficiently skew purchasing decisions.

5.60 Turning to the third element of the Appellate Body's analysis, that of protective application, the United States argues that because pisco has a 73.8% share of the Chilean distilled spirits market as of 1996,³³⁶ the higher relative taxes on all other distilled spirits could be expected to afford protection to pisco. Furthermore, all pisco is by definition domestic. According to Chilean Law No. 18,455/85 and Law-Decree 78/1986, "pisco" is a protected geographical indication that can only be used for Chilean-made pisco. Therefore, the dissimilar taxation of the Old Chilean System was applied so as to afford protection to domestic production.



5.61 The United States argues that the Old Chilean System resulted in the taxation of 89.1% of all domestic spirits at the lowest rate, 10.6% of all domestic spirits at the median rate, and a mere 0.3% of all domestic spirits at the highest rate. In turn, the Old Chilean System taxed 53.8% of all imported

³³⁴ See EC First Submission, paras. 61-78.

³³⁵ Throughout the existence of Decree-Law 825/1974, the tax rates for whisky and for other distilled spirits fluctuated repeatedly; however, the tax rate for pisco remained steady at 25%.

³³⁶ See Table 9A in EC First Submission.

spirits at the highest rate, 46.2% of all imported spirits at the median rate, and no imported spirits at the lowest rate.³³⁷

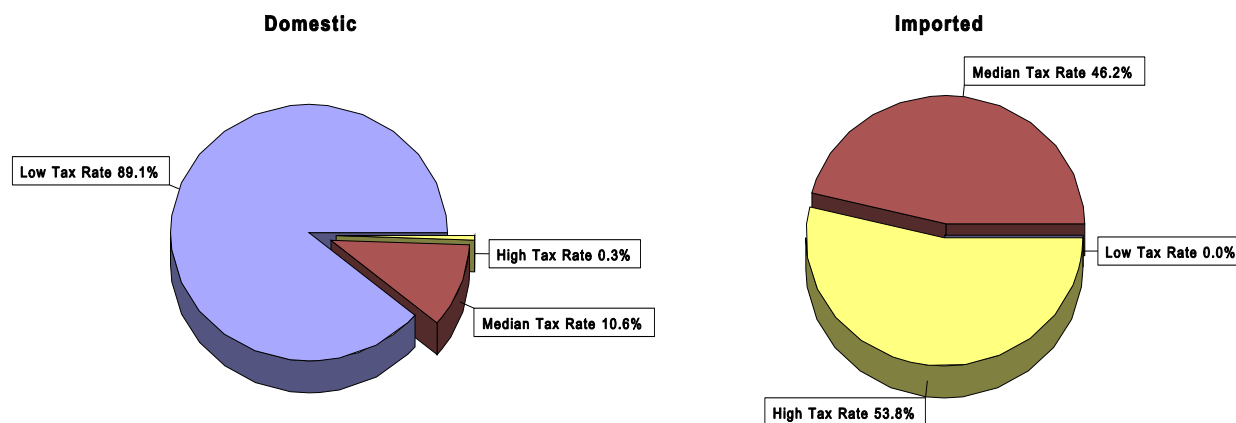
5.62 The highest tax rate, applied almost exclusively to imports, was 180% greater than the lowest rate. In the *Japan – Taxes on Alcoholic Beverages II* and *Korea – Taxes on Alcoholic Beverages* cases, the differences in the arbitrary rates and their relative effects on imports and domestic products were themselves evidence of a protective structure; in the case of the Old Chilean System, the structure was also arbitrary in that it established different tax rates for the three product categories, with no discernible rationale.

(c) Transitional System

5.63 The United States notes that the present tax system is a transition from the old to the new one. Established by Law 19,534, it will remain in place until 30 November 2000. Even Chilean government officials recognized the discriminatory nature of the Old Chilean System, and the features duplicated in the transitional regime permit a similar conclusion with respect to this substitute.

5.64 According to the United States, an examination of the Transitional System reveals that pisco and directly competitive or substitutable imported distilled spirits are also not “similarly taxed”. The Transitional System maintains the same, distinct product categories as the Old Chilean System for pisco, whisky and other spirits. And although the Transitional System reduces the tax rate for whisky from 70% to 53% over a span of three years, the tax discrimination remains, since whisky is still taxed much more than pisco (25%) and other spirits (30%).

Transitional Tax Regime



5.65 With respect to the third element of the analysis, the Transitional System's design, architecture and structure reveals a measure that again taxes 89.1% of all domestic spirits at the lowest rate, 10.6% of all domestic spirits at the median rate, and a mere 0.3% of all domestic spirits at the highest rate. Similarly, it taxes 53.8% of all imported spirits at the highest rate, 46.2% of all imported spirits at the median rate, and no imported spirits at the lowest rate. In fact, the only difference

³³⁷ See Graph 1. To calculate the Chilean market shares of domestic and imported products in each tax regime (Graphs 1, 2 and 3), the United States utilises the 1996 sales data from the ISWR report, as provided in EC Exhibit 19, and Tables 1, 9A and 9B of EC First Submission. The 1996 data are the most recent and most complete available. Furthermore, the submission excludes from these calculations the "other" spirits category from the ISWR report, because the report is silent as to the identity and the alcohol content of the vast majority of these spirits. See EC Exhibit 19, p. 97. (Also, see U.S. Exhibit 2 for details of these calculations).

between the Old Chilean System and the Transitional System is the magnitude of the dissimilar taxation: While the medium tax rate remains 20% greater than the lowest tax rate, the highest tax rate is reduced from 180% greater than the lowest rate to 112% greater than the lowest rate. Yet despite this reduction, the tax differential remains grossly disproportional. As with the Old Chilean System, the application of taxes based solely on the identification of directly competitive or substitutable products, the fact that the protected product is exclusively domestic, and the magnitude of the tax differentials between imports and domestic products, together establish a protective structure.

(d) New Chilean System

5.66 The United States notes that the New Chilean System, also established by Law 19,534, is scheduled to take effect on 1 December 2000. While this regime is not yet in effect, it is nevertheless the proper subject of these proceedings as it is a mandatory measure the details of which have already been determined.³³⁸

5.67 The New Tax System will differ from the Old and Transitional Systems in that it will tax on the basis of alcohol content. Distilled spirits with an alcohol content of 35 degrees or less will be taxed at 27% *ad valorem*. Yet for distilled spirits with an alcohol content of over 35 degrees, the rate will escalate in 4 percent increments for each additional degree of alcohol, topping off at the 47% rate for spirits bottled at over 39 degrees alcohol content.

5.68 The United States notes that the EC submission demonstrates that despite eliminating the explicit product categories found in the two previous regimes, the New Chilean System will maintain dissimilar taxation between domestic and imported distilled spirits: 89.6% of all pisco sold is bottled at 35 degrees or lower, whereas whisky, vodka, rum, gin and tequila by law must all be bottled at 40 degrees or higher. The New Chilean System thus will continue to ensure that a tax rate of 27% is to be applied to most domestic spirits, while a 47% rate be applied to most imported spirits.

5.69 As for protective application, the United States notes that the New Chilean System will differ from past systems by relying on apparently neutral criteria, i.e. alcohol content and value. However, these criteria will continue to afford protection to domestic production. The vast majority of products to which the lowest tax rate will apply will still be pisco, an inherently domestic product which is also the major distilled spirit sold in Chile, while the highest tax rate will still apply to most imported products.

5.70 The United States argues that in the context of the facts and circumstances of this case, Chile's use of alcohol content for taxation purposes is an effort to perpetuate the relatively higher rates applied to imports. The alcohol content of most imported spirits is well known, and in fact fixed by Chilean law. By statute, Chile requires that whisky, rum, vodka, gin and tequila be at least 40 degrees in alcohol content. The same law dictates that brandy must be a minimum of 38 degrees, pisco must be a minimum of 30 degrees, and liqueurs can range from 25 degrees and upwards, depending on the type of liqueur.³³⁹ Thus, for example, whisky can only be sold as "whisky" in Chile if it is subject to the maximum tax rate possible.

5.71 The United States further argues that, as a result of well-established industry practices and legal standards required by many of the major distilled spirits markets, most international whisky producers bottle their product at a minimum alcohol content of 40 degrees. Similarly, most international producers of rum, vodka, gin and tequila bottle their products at around 40 degrees

³³⁸ See Panel Report on *United States - Taxes on Petroleum and Certain Imported Substances*, *supra.*, para. 5.2.2.

³³⁹ Chilean Decree 78/1986, implementing Law No. 18,455/85.

(typically no lower than 37.5 degrees).³⁴⁰ Producers generally prefer to maintain the same alcohol content, regardless of market requirements, because of the fact that alcohol strength contributes to each product's characteristics and taste. Thus, by pegging the tax rates to alcohol content, the Chilean regime will apply its rates on the basis of a well-known, inherent attribute of each product and will thereby continue to protect pisco from competition from whisky and other imports.

5.72 According to the United States, further evidence of the Chilean law's protective structure is the arbitrary choice of 35 degrees as the dividing line between a straight ad valorem rate of 27% and rates that increase considerably. Very few imported spirits are bottled under 35 degrees alcohol content; indeed, most imported spirits are legally required to be over this 35 degree threshold. As pisco is the only major distilled spirits category with the flexibility to fall below the threshold, and in fact most are bottled at an alcohol content of 35 degrees or less, pisco will once again be effectively singled out for preferential tax treatment.

5.73 The United States argues that the steeply increasing tax rates on imports of over 35 degrees alcohol content, compared to the flat rate applied to pisco below that threshold, can only be explained as taxation applied to afford protection to pisco. Although one GATT panel properly found that gradual increases in rates may support the determination that a progressive tax structure is non-protectionist in its structure,³⁴¹ in this case the four percent tax increase for each additional degree of alcohol content will create a disproportionate increase in tax for spirits with 40 degrees alcohol content or more. Thus when comparing two bottles of spirits with equal value, the tax on the 40 degrees spirit will be 74% greater than the tax on the 35 degrees spirit. Moreover, the EC submission describes evidence of the anticipated discriminatory effect of the new tax regime and the protective purpose of the threshold, as revealed from the drafting process of the new legislation.³⁴²

5.74 The United States further argues that the protectionist structure is further evidenced by the overall relative impact of the new regime on imports and domestic products. The New Chilean System will tax the vast majority, 83.9%, of all domestic spirits at the lowest possible rate, and only 12.3% of all domestic spirits at the highest possible rate. Conversely, the new regime will tax 94.5% of all imported spirits (a share higher than the previous two regimes) at the highest possible rate, but only a mere 4.5% of all imported spirits at the lowest possible rate.³⁴³

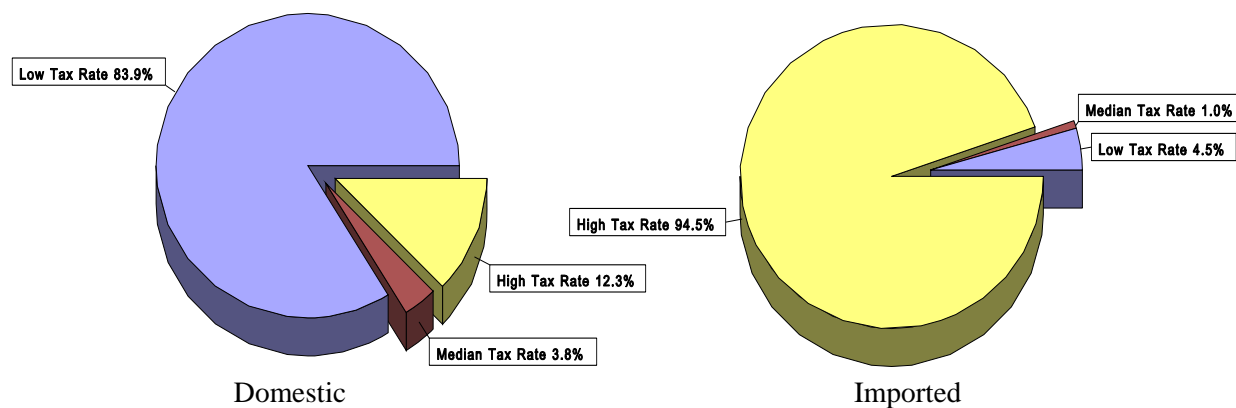
³⁴⁰ See U.S. Exhibit 3.

³⁴¹ See Panel Report on *United States - Taxes on Automobiles*, *supra.*, para. 5.14.

³⁴² See EC First Submission, paras. 61-78.

³⁴³ The United States notes that these calculations for the new tax regime are made with the assumption that all liqueurs are taxed at the lowest rate possible, given their ability to be bottled at 35 degrees alcohol content or less (in reality, while most domestically produced liqueurs (*e.g.*, creme de menthe, flavoured brandies) are bottled at below 35 degrees, most imported liqueurs (*e.g.*, Drambuie, B&B) are bottled at above the threshold). Furthermore, these calculations exclude brandy because, with an ability to be bottled at 38 degrees alcohol content, it can be taxed at 39%, a median tax rate.

New Tax Regime



5.75 The United States observes that the 12.3% of all domestic spirits to be taxed at the highest possible rate, stated above, will consist mostly of *pisco reservado* and *gran pisco*, two brands of pisco.³⁴⁴ However, one must bear in mind that pisco is the only major distilled spirits category given the flexibility by law to be bottled at 35 degrees alcohol content or below. Thus, while the domestic producers of pisco may purport to bottle a small portion of their production (10.4%) at 40 degrees or more, they can at any time choose to reduce the alcohol content of these brands and still retain the identity of "pisco". On the other hand, Chile does not provide this freedom to the producers of the major imported spirits, therefore ensuring that in the New Chilean System, whisky, rum, gin, vodka and tequila will all be "locked" into the highest tax rate imposed.

5.76 According to the United States, the New Chilean System is promulgated to provide continued protection to domestic spirits. In the US view, Chile would have the Panel conclude that its New Chilean System is non-discriminatory simply because it will allow some imported spirits to enjoy the lowest tax rate possible while imposing the highest tax rate on a few of its domestic products. However, the products in these circumstances are few and far between, and act as no more than mere token gestures. In short, Chile will again fail to provide non-discriminatory treatment for its distilled spirits market.

5.77 The United States concludes that Old Chilean System applied its lowest tax rate to 89.1% of all domestic spirits and its highest tax rate to 53.8% of all imported spirits. This uncontested discriminatory treatment between domestic and imported spirits continues in the transitional tax regime which, while lowering the magnitude of the tax differential (between the highest tax rate and the lowest tax rate) from 180% to 112%, is a mirror image of the Old Chilean System. Then in the year 2000, the New Chilean System will further forward this tradition of dissimilar treatment by providing its lowest tax rate to 83.9% of all domestic spirits, while imposing its highest tax rate on 94.5% of all imported spirits. Furthermore, the New Chilean System will effectively increase the *ad valorem* tax for most U.S. imports from 30% to 47%.³⁴⁵ It is obvious that all three tax regimes operate with the same practical effect.³⁴⁶ And in all cases, the exclusive carve-out of preferential tax treatment for domestic production is clear.

³⁴⁴ See U.S. Exhibit 2.

³⁴⁵ According to the United States, in the old and transitional regimes, approximately 61.4% of all U.S. exports to Chile (rum, gin and vodka) are categorized as "other distilled spirits", and taxed at the 30% rate. However, in the new regime, these spirits will be taxed at the maximum 47%, an increase in tax rate of 56.7%.

³⁴⁶ See Table 1 and U.S. Exhibit 4.

Table 1

	OLD REGIME		TRANSITIONAL REGIME		NEW REGIME	
	Domestic	Imported	Domestic	Imported	Domestic	Imported
Low Tax Rate	89.1%	0.0%	89.1%	0.0%	83.9%	4.5%
Median Tax Rate	10.6%	46.2%	10.6%	46.2%	3.8%	1.0%
High Tax Rate	0.3%	53.8%	0.3%	53.8%	12.3%	94.5%
TOTAL	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

VI. INTERIM REVIEW

6.1 In letters dated 25 February 1999, the European Communities and Chile requested an Interim Review by the Panel of certain aspects of the Interim Report issued to the parties on 15 February 1999. The parties did not request an Interim Review meeting.

6.2 The European Communities has argued that paragraphs 2.1 and 2.3 and footnote 1 should be amended to reflect the fact that Chilean Law No. 19.534 did not repeal and replace Decree 825/74, but instead amended it. We changed the Descriptive Part of the Report in this regard to reflect Chile's legal characterization of its own law. While the EC has pointed out that the title of Law No. 19.534 refers to it as a modification, we will accept Chile's characterization of its legislation in this regard. As we noted in footnote 1, we do not find the characterization of whether the law is a replacement or a modification to be of any substantive importance to our Findings.

6.3 With respect to the Findings, the European Communities has made suggestions for clarifications with respect to paragraph 7.46 and footnotes 370, 390 and 407. We generally agree with these points and have made changes accordingly.

6.4 With respect to paragraph 7.35, the European Communities argues that the proper reference is to the 1998 SM Survey rather than to the 1997 SM Survey and that this paragraph and the following one should be moved. However, these paragraphs refer to Chile's disagreement with both surveys. One of the references in paragraph 7.35 was incorrect and we have changed it. Otherwise the paragraphs are accurate and have not been amended.

6.5 The European Communities claims that the statements in paragraph 7.60 were not in reference to the 1998 SM Survey, but instead referred to another section of the EC's First Submission. The references in paragraph 7.60 et seq., are taken from the section of the EC's first submission beginning at paragraph 145 and were direct references to the 1998 SM Market Survey. The Tables referred to therein are derived from that survey. Upon further consideration, we decided that it would be helpful to reverse the data references in paragraphs 7.60 and 7.61 and modify the language of these paragraphs in order to further clarify this point.

6.6 With respect to paragraphs 7.71 and 7.77, the European Communities strongly objects to the characterization of the cross-price elasticity shown in the 1995 Gemines study as being "low". We continue to be of the view that a cross-price elasticity of .26 is low. However, we also note our extensive discussion of the reasons why this *estimated* cross-price elasticity is lower than the actual

ratio would be, which is also the conclusion reached by the authors of the study. Therefore, we decline to change the paragraphs.

6.7 The European Communities argues that paragraph 7.100 does not accurately reflect their argument. After reviewing their statement and submissions to the Panel, we have made some modifications to this paragraph.

6.8 The European Communities states that the third sentence of paragraph 7.105 is not accurate in that an *ad valorem* system would not provide similar taxation unless it applied the same rates or rates with less than *de minimis* differences. This is what we intended when referring to "purely" *ad valorem* systems. Nonetheless, we will clarify the reference. We consider the remainder of the paragraph accurate and appropriate in its qualifications and decline to further modify it.

6.9 The European Communities requests that we eliminate footnote 420 because reference to other taxation systems is not relevant to this dispute. Furthermore, the European Communities argues that the discussion is beyond the Panel's Terms of Reference. As the European Communities correctly notes, we stated in footnote 430 that inquiry into other tax systems for alleged inconsistency with GATT rules is not relevant. However, Chile offered this argument by analogy and, in our view, it is worth noting some of the specific problems that can arise from such arguments. In our view, this fuller explanation serves a useful purpose in this regard. We specifically noted in the footnote that the examination required to determine the accuracy of the analogy would in fact be beyond the Panel's terms of reference. Accordingly, we decline to delete this footnote.

6.10 The European Communities objects to paragraph 7.109 for the same reasons described above in regard to footnote 420. We decline to make the requested change for the same reasons discussed in regard to that footnote.

6.11 The European Communities argues that paragraph 7.121 mis-characterizes their position on the question of the Chilean legislative process. In our view, the language requested by the European Communities is merely a more in-depth description of their position than what is contained in paragraph 7.121. We note that a full description of the EC position can be found in the Descriptive Part of the report at paragraphs 4.559-4.585. In our view, paragraph 7.121 is accurate and we decline to make the requested change.

6.12 The European Communities argues that paragraph 7.122 does not address the EC argument. In its interim review request, the European Communities states that:

The Pisco industry was not trying to "push a tax burden onto another" but, rather to attract upon itself an additional tax burden. Neither Chile, nor now the Panel, have given any satisfactory explanation for that unusual request.

6.13 The European Communities then goes on to argue that we should draw inferences from the alleged willingness of the Chilean government to negotiate certain benefits with one constituent but not another. In our view, there is no basis for the EC's demand that the Panel provide it with a "satisfactory explanation" of the Chilean legislative process. Indeed, the inferences that it wishes us to draw are precisely the sort of delving into domestic politics that previous panels and the Appellate Body have declined to do. The European Communities does not provide direct evidence of the Chilean government position. Rather it wishes us to conduct an investigation to draw inferences from a series of policy negotiations. It is manifestly unclear what standards we should use to evaluate such discussions and negotiations or what the authority is for conducting such an investigation of the Chilean legislative processes. We agree with the guidance provided by the Appellate Body in this regard and decline to make the changes requested by the European Communities.

6.14 The European Communities requests that we change subparagraph 7.131(iv) for the reasons it requested we change paragraph 7.121. We decline to make this change for the same reasons we declined to change paragraph 7.121.

6.15 The European Communities has asked us to revise the summary of its argument in paragraph 7.137 to better reflect its argument. We have made some changes to that paragraph to better reflect its argument.

6.16 With respect to paragraph 7.146, the European Communities suggests that it is inaccurate to state that "to a certain extent both parties are correct in their arguments" because the Panels conclusions in the following two paragraphs accord with the EC position. We noted that Chile argued that we should not review the legitimacy of its policy objectives. We agree. However, we also agree with the EC's argument that the lack of a rational connection between the stated objectives and the measure was evidence of protective design, structure and architecture. Thus, we consider our summary in paragraph 7.146 accurate and decline to make the requested change.

6.17 Chile notes its disappointment in and disagreement with the Panel's conclusions in this dispute.

6.18 In its specific comments, Chile disagrees with our characterization of their position in paragraph 7.28. Chile states that it provided arguments against the determination that HS 2208 is the "relevant market". However, this paragraph is not concerned with a determination of "relevant markets" and we did not use that term. Rather it deals on the one hand, with the identification of the appropriate category of certain imports and, on the other, with the appropriate categorization of certain domestic products. We have reviewed the record once again and do not find where Chile argued that the list of distilled alcoholic beverages identified by HS 2208 was not the appropriate category of imported products. Chile also never argued that particular sub-categories of HS 2208 should be excluded, as was done, for example, in the panel findings in *Korea – Taxes on Alcoholic Beverages*.

6.19 While Chile did argue that various distinctions between products undercut the EC's arguments with respect to the question of directly competitive or substitutable products, this does not go to the question of whether certain distilled alcoholic beverages contained within HS 2208 should be grouped separately or excluded from the Findings. Furthermore, we discussed various sub-categories of products at various points in the Findings when there were differences in products that we felt warranted further examination (see, for example, paragraph 7.54). Had such examination revealed differences that justified finding certain products not within the groupings utilised or not directly competitive or substitutable, we would have made such a determination. Finally, in discussing this question in paragraph 7.28, we specifically discussed why such grouping of products would not prejudice the substantive discussion of the question of whether the imported and domestic products are directly competitive or substitutable.

6.20 Chile also made the following argument in regard to paragraph 7.28:

Chile also provided information proving that the different kinds of pisco are marketed in different markets and are produced using different technology. If it is later argued that a diluted whisky is not whisky, why should a 43° pisco diluted to 30° continue to be a *Gran Pisco*.

6.21 We note again that this argument really goes elsewhere; namely, to the substantive Findings on "dissimilar taxation" or "so as to afford protection" relating to Chile's argument that products can easily be diluted to achieve tax parity. However, we note that it is a matter of Chilean law that all pisco is grouped together regardless of its strength in the Old Chilean System and the Transitional

System and that the geographic denomination under Chilean law of "pisco" does not refer to alcohol strength. We also note that it is a matter of Chilean regulation that whisky and other products lose their generic names if they are diluted. Thus, the term pisco is available to spirits at various levels of alcohol content while the term whisky is available only at 40° of alcohol content and above. We are not convinced to change paragraph 7.28.

6.22 Chile further argued that it showed that "when wine is included in the regression, for example the coefficient ceases to become statistically significant". This argument also does not really go to the point of the discussion in paragraph 7.28. Nonetheless, we note that Chile supplied a new regression analysis, so it is not accurate to state that the results change when wine is added to *the* regression. We discussed the methodological problems with the new Chilean analysis as well as the others submitted. We also discussed the question of including wine (and beer) in our overall analysis. Our conclusion was that it was possible that wine and beer are also directly competitive or substitutable with pisco. However, that does not refute the extensive evidence that pisco is directly competitive or substitutable with the other distilled spirits. This also appears to be the conclusion recently reached by the Chilean competition authorities.

6.23 With respect to paragraph 7.41, Chile disagrees with our use of the Adimark Survey as relevant evidence. We recognized its limitations based on sample size and we specifically stated that we did not wish to make too much of the survey. However, we found it both relevant and useful in that it was a study presented to the Chilean legislature and not one developed for purposes of this dispute. Chile states that we should not draw any conclusions about its value "without proper knowledge of the market". However, we specifically stated that we took note of the survey because of its consistency with other market information.

6.24 Chile also argued with respect to the Adimark survey that the panel attached greater validity to one segment of the market than another. Chile's criticism implies that there must be high degree of current substitutability among all portions of Chilean society for products to be considered directly competitive or substitutable. That is not correct. We found it to be relevant evidence that a focus group representing a significant portion of Chilean society (the portion with the highest disposable income and therefore a proportionally greater share of domestic consumption) showed a high level of willingness to substitute whisky for pisco. We also noted that another segment would be interested in trying whisky although the second group of respondents thought they would revert to consumption of pisco later. Complainants do not have to show that all consumers would shift all consumption; rather, that some portion would under some circumstances. There is then a question which we have addressed at length as to whether such amount of substitutability is sufficient. In our view, the weight we have accorded to the Adimark survey is consistent with its limitations and its conclusions. We decline to make the changes requested by Chile.

6.25 Chile disagrees with footnote 393 regarding its inability to provide the 1996 Gemines Study pursuant to requests by the European Communities and the Panel. In Chile's view this footnote misallocates the burden of proof and implies an uncooperative position by Chile. Chile further notes that it is not obligated to provide evidence contrary to its own arguments. Chile also states that the Panel should have given more credence to the fact that the study was the property of a private party. First, the question here is not one of allocation of the burden of proof. The European Communities is required to present evidence to establish its claims. With respect to this piece of its overall evidence, the European Communities presented statements made in the Chilean press to the effect that the 1996 Gemines Study showed a high degree of substitutability between whisky and pisco. Our statement in footnote 393 was that Chile (and its industry) had foregone the opportunity to rebut this evidence by not presenting the study for examination. Second, we made no statement about Chile being uncooperative. Chile adopted a fully cooperative position during the whole period of the proceeding, of which we are appreciative. Third, we specifically noted that the study was in the pisco industry's hands and the industry had refused to provide it. As we noted, it would be an artificial distinction to

state that we would refuse to accept the un rebutted information provided by the European Communities as it referred to a study that we could not see ourselves because it was retained in the hands of the directly interested domestic Chilean industry.

6.26 Finally, we specifically noted that there is no compulsory discovery under the DSU. However, we do find it regrettable that any industry (or any Member, whether complainant or respondent) would not submit requested relevant evidence for consideration by a panel. We note that we are troubled by Chile's statement that its only duty is in "not obstructing the work of the panel". Article 13 of the DSU states that:

A Member should respond promptly and fully to any request by a panel for such information as the panel considers necessary and appropriate.

6.27 We think this treaty obligation calls for something more than a lack of obstruction. And, in fact, Chile's approach throughout the proceedings was constructive. Our only conclusion here was that, given that the Chilean industry had refused the repeated requests to produce the report, we would accept the EC's un rebutted evidence about the report's conclusions. Accordingly, we decline to make the requested changes.

6.28 With respect to paragraph 7.74, Chile notes that its initial basis for comparing prices was mistaken but was later corrected. We agree and will change the paragraph accordingly.

6.29 Chile claims that, with respect to paragraph 7.76, the conclusions on cross-price elasticity of pisco and imported distilled spirits is not based on any evidence and notes that only two products were involved: whisky and pisco. As we noted, pisco and whisky are two of the most dissimilar products involved. It follows that the evidence for the intermediate products would be supportive of the same conclusions. We must also note that we discussed at great lengths the weaknesses of the studies submitted, but found them useful supportive evidence to be considered along with other factors also discussed at length. We decline to make the change requested.

6.30 Chile has requested that in paragraph 7.105 we not state that specific tax systems are not generally considered to be applying dissimilar taxation. While not necessarily agreeing with some of Chile's reasoning in its comments, we note that we have found that the New Chilean System is an *ad valorem* system qualified by reference to alcohol content and that it is not a specific tax system. Therefore, the statement is irrelevant and we agree to remove it.

6.31 Chile disagrees with our statements in paragraph 7.109 regarding luxury tax systems and claims that the New Chilean System is a type of luxury tax system. As pointed out in this paragraph, we disagree. A system where *ad valorem* rates change according to alcohol content rather than value is not a luxury tax system. The paragraph illustrates our conclusion and we decline to change it in this regard.

6.32 Chile objects to footnote 430 claiming that it did not attempt to justify its own measures by reference to other Member's policies. It is the case that Chile did not admit that its measures were GATT-inconsistent and then attempt to defend them by reference to other Members' laws. However, as Chile again acknowledges, it did argue at great length that, in its view, to find Chile's measures GATT-inconsistent would compel a finding that other Members' laws were also inconsistent. Either way, the other Members' laws are irrelevant to our analysis. We will amend this footnote to further clarify Chile's position and our conclusions on this matter.

6.33 Chile argues that paragraph 7.143 is not correct because Chile disagrees that the products discussed are directly competitive or substitutable. Chile states in its Interim Review comments that such competitive conditions exist only with respect to directly correlated alcoholic content beverages.

Chile did not present its arguments in this fashion during the meetings or in its submissions. We are unaware of any evidence that supports an argument that distilled alcoholic beverages are directly competitive or substitutable only with those that contain the same alcohol content. Nonetheless, we will amend the paragraph to more clearly reflect that the statements are our conclusions and not Chilean arguments.

6.34 Chile disagrees with paragraph 7.149 and claims that we have confused two different concepts. According to Chile "revenue neutrality" does not refer to maintaining the same tax revenue but also takes into account issues of progressivity or regressiveness of application. We disagree. It is quite obvious that "revenue neutrality" refers to just what it says: achieving the same amount of *revenue*. In our view, it is not correct to conclude that "revenue neutrality" also includes an element of social impact neutrality. To so argue ignores the plain meaning of the word "revenue" and is unsupported by either logic or the evidence. We decline to change paragraph 7.149.

6.35 With respect to paragraph 7.150, Chile notes that there is more local production of some high alcohol spirits than imports. This is already noted and considered in our Findings. We decline to change this paragraph.

6.36 In paragraph 7.152, we stated that there "appears to be no correlation between value and alcohol consumption." That is our conclusion. We then continue by noting that there would be an inverse relationship, *if any*. Chile disagrees with the reference to a possible inverse relationship, stating that this further statement would only be true if the products were perfect substitutes. Chile's comment is not on our conclusion, as much as it is on the further statement about a possible inverse relationship. We do not see the basis for Chile's statement that this further statement is only true if products are "perfect substitutes". We acknowledge that Chile would not agree with the point given its disagreement with our conclusions on the issue of "directly competitive or substitutable". Nonetheless, given our conclusions on that issue, we think the paragraph is accurate and decline to change it.

6.37 Chile disagrees with our assessment in paragraph 7.154 that the stated policy objectives are not achieved and that, even if they were, it would not be evidence of discrimination but could be due to some other factor. We found no evidence of these other factors here. Therefore, we found this to be supporting evidence of our Finding. As with many other points discussed in the Findings and in this Interim Review, it must be remembered that we did not view any single factor in isolation. In weighing all the evidence, such things as a lack of rational connections between stated objectives and resulting measures constitutes *a* factor among others. Chile also argued here that competing objectives results in achievement of second best solutions to all the problems. However, we found a lack of rational connections, including second best ones. We decline to change paragraph 7.154.

6.38 With respect to paragraph 7.155, Chile argues that there is an important distinction between laws and regulations specifically with respect to the regulation concerning minimal alcohol content of beverages. In Chile's view, regulations are more flexible. We think the term "laws" is broad enough to cover both legislation and regulations. Nonetheless, we will change paragraphs 7.145, 7.155 and 7.159 and footnote 437 to reflect Chile's distinction. As we explicitly noted, we make no findings concerning this regulation, but it does constitute a relevant fact of our inquiry. Also, we stated that the Chilean argument concerning dilution of products was not persuasive because such products would need to change both their generic names *and* certain physical characteristics.

6.39 In regard to paragraph 7.156, Chile states that it does not attempt to justify its tax regime by referring to the fact that it applies duties lower than the bound rates. Rather, Chile states that it provided this as an example of how Chile does not use such instruments despite their legality. Chile says it offers the example as an indication of the intent and nature of its policy instruments. The very point we made in paragraph 7.156 is that such good intentions in one area are not relevant to an

examination of a completely different measure. We do, however, agree that Chile did not attempt to "justify" the tax measure in question, because Chile in fact still maintains that the measure is GATT-consistent and therefore not needing justification. We amended the paragraph accordingly.

6.40 Chile disagrees with the summary paragraph 7.159. On one particular point, Chile notes that its prior tax systems have not been found inconsistent with GATT or WTO obligations. We note that the structure of the Old Chilean System is *precisely* the same as the Transitional System. Only the rates of taxation differ. Other than changing the reference to the product labelling measure (which is not at issue) to reflect Chile's prior comment that it is a regulation not legislation, we decline to further amend this paragraph.

VII. FINDINGS

A. CLAIMS OF THE PARTIES

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

7.2 The European Communities claims that³⁴⁷:

- (i) the Transitional System, which is applicable through 30 November 2000, is contrary to GATT Article III:2, second sentence, because it provides for the imposition of lower internal taxes on pisco than on other directly competitive or substitutable imported spirits, which fall within the tax categories of "whisky" and "other spirits", so as to afford protection to Chile's domestic production;
- (ii) the New Chilean System, which will become applicable as of 1 December 2000, is also contrary to Article III:2, second sentence, because it results in the imposition of lower taxes on pisco with an alcohol content of 35° or less than on other directly competitive or substitutable imported spirits which have a higher alcohol content, so as to afford protection to Chile's domestic production.³⁴⁸

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

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

³⁴⁷ The European Communities notes that in its panel request, it also invoked a violation of GATT Article III:2, first sentence. Even though certain spirits exported from the European Communities to Chile (including in particular certain types of brandy) may be considered as being "like" to pisco, the European Communities has decided not to pursue that claim, given that those spirits are in any event "directly competitive or substitutable" with pisco.

³⁴⁸ The European Communities argues that the New Chilean System already constitutes mandatory legislation, and as such, it may be the subject of dispute settlement under the WTO Agreement, citing Panel Report on *United States – Taxes on Petroleum and Certain Imported Substances*, BISD 34S/136, paras 5.2.1-5.2.2.

B. INTERPRETATION OF ARTICLE III:2

7.5 Article III:2 provides two standards for examining complaints about a Member's internal taxation laws. The first sentence of Article III:2 provides:

The products of the territory of any Member imported into the territory of any other Member shall not be subject, directly or indirectly, to internal taxes or other internal charges of any kind in excess of those applied, directly or indirectly, to like domestic products.

The second sentence provides:

Moreover, no Member shall otherwise apply internal taxes or other internal charges to imported or domestic products in a manner contrary to the principles set forth in paragraph 1.

Paragraph 1 of Article III in turn provides:

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

7.6 The meaning of the second sentence in light of its reference to the first sentence is further clarified in *Ad Article III* as follows:

A tax conforming to the requirements of the first sentence of paragraph 2 would be considered to be inconsistent with the provisions of the second sentence only in cases where competition was involved between, on the one hand, the taxed product and, on the other hand, a directly competitive or substitutable product which was not similarly taxed.³⁴⁹

7.7 Thus, the first sentence of Article III:2 examines whether products of an exporting country are taxed in excess of the taxes on the "like" domestic product. The second sentence examines whether products of an exporting country are taxed similarly to domestic products which are "directly competitive or substitutable." Both sentences first examine the relationship between the domestic and imported products; however, the second sentence involves additional and different inquiries with respect to two other elements; namely, an examination of the *extent* of the difference in taxation³⁵⁰ and whether the taxation differences are applied so as to afford protection to the domestic industry.

7.8 In *Japan – Taxes on Alcoholic Beverages II*, the Appellate Body considered the overall interpretation of Article, and stated that:

³⁴⁹ *Ad Article III* has equal stature under international law as the GATT language to which it refers, pursuant to Article XXXIV. See also Appellate Body Report on *Japan – Taxes on Alcoholic Beverages* (hereafter, "*Japan – Taxes on Alcoholic Beverages II*"), adopted on 1 November 1996, WT/DS8/AB/R, WT/DS10/AB/R, WT/DS11/AB/R, p. 24.

³⁵⁰ If the products are determined to be "like" then *any* taxation of the imported product in excess of the domestic product is prohibited. There is no *de minimis* possibility as there is under the second sentence where *Ad Article III* provides only that they must be "similarly taxed."

The broad and fundamental purpose of Article III is to avoid protectionism in the application of internal tax and regulatory measures. More specifically, the purpose of Article III is to ensure that internal measures are "not applied to imported or domestic products so as to afford protection to domestic production."³⁵¹

7.9 According to the Appellate Body, the terms of Article III:1 must be given their ordinary meaning, in light of the overall object and purpose of the WTO Agreement. Taking this approach, the Appellate Body affirmed that Article III:1 contains a general principle, while Article III:2 provides for specific obligations regarding internal taxes and internal charges. The Appellate Body stated that:

Article III:1 articulates a general principle that internal measures should not be applied so as to afford protection to domestic production. This general principle informs the rest of Article III. The purpose of Article III:1 is to establish this general principle as a guide to understanding and interpreting the specific obligations contained in Article III:2 and in other paragraphs of Article III.³⁵²

7.10 The Appellate Body noted that Article III:2, second sentence, unlike the first sentence, specifically invokes Article III:1. In this regard, the Appellate Body noted that three issues must be addressed to determine whether an internal tax measure is inconsistent with Article III:2, second sentence:

- (i) the imported products and the domestic products are "directly competitive or substitutable products";
- (ii) the directly competitive or substitutable imported and domestic products are "not similarly taxed"; and
- (iii) the dissimilar taxation of the directly competitive or substitutable imported domestic products is "applied so as to afford protection to domestic production".³⁵³

7.11 We also note that the burden of proof in cases such as this has been discussed at length by the Appellate Body in *United States -- Shirts and Blouses*.³⁵⁴ It is up to the European Communities as complainant to present evidence sufficient to establish the case that the Chilean measures in question are inconsistent with Chile's obligations under Article III. If they do so, it is then necessary for Chile to bring forward evidence and arguments to disprove the claim. At that point, it is up to a panel to carefully weigh all the evidence and reach its conclusions based upon the results of that weighing.

C. "DIRECTLY COMPETITIVE OR SUBSTITUTABLE"

1. General

7.12 The complainant in this case has not argued that any of the imported or domestic products are "like". We shall, therefore, proceed exclusively under Article III:2, second sentence, which is concerned with the question of direct competitiveness or substitutability.

³⁵¹ Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II*, *supra.*, p.16.

³⁵² *Ibid.*, p 18.

³⁵³ *Ibid.*, p. 24. See also Appellate Body Report on *Canada – Certain Measures Concerning Periodicals* (hereafter, "*Canada – Periodicals*"), adopted on 30 July 1997, WT/DS31/AB/R, pp 24-25 and Appellate Body Report on *Korea – Taxes on Alcoholic Beverage*, adopted on 17 February 1999, WT/DS75/AB/R, WT/DS84/AB/R, para. 107.

³⁵⁴ Appellate Body Report on *United States – Measures Affecting the Imports of Woven Shirts and Blouses from India* (WT/DS33/AB/R), pp. 12-17. See also Appellate Body Report on *Korea – Taxes on Alcoholic Beverages*, *supra.*, paras. 155-158.

7.13 As a prerequisite to the analysis of the evidence presented, it is important to establish the correct interpretation of the term "directly competitive or substitutable". In this regard, the Panel is guided by Article 31 of the Vienna Convention on the Law of Treaties ("Vienna Convention"), that summarizes the international law rules for the interpretation of treaties. Article 31.1 of the Vienna Convention provides that terms shall be interpreted in good faith, in accordance with the ordinary meaning of the terms in their context, and in light of the object and purpose of the treaty. Article 31.2 provides further, that the context includes the full text, the preamble, the annexes and any mutually agreed interpretive language. Article 31.3 provides that account shall also be taken of any subsequent practice or interpretations as well as relevant rules of international law.

7.14 The category of "directly competitive or substitutable" products is broader than the "like product" category covered under the first sentence. The Appellate Body in *Japan – Taxes on Alcoholic Beverages II* stated that how much broader this category should be "is a matter for the panel to determine based on all the relevant facts in that case".³⁵⁵ It will be important to look at not only such matters as physical characteristics, common end-uses, and tariff-classifications, but also at the market. The Appellate Body also stated that it is appropriate to examine elasticity of substitution as a means of examining the relevant markets.

7.15 The Appellate Body in *Japan – Taxes on Alcoholic Beverages II* agreed with the reasoning of the panel with regard to the analysis of directly competitive or substitutable products. That panel made two important observations. First, the panel noted that the responsiveness of consumers to various products offered in the market may vary from country to country.³⁵⁶ Second, the panel cautioned that differences in responsiveness of consumers to various products should not be influenced or determined by internal taxation because "a tax system that discriminates against imports has the consequence of creating or even freezing preferences for domestic goods."³⁵⁷ The Appellate Body stated that no single criterion is decisive in determining whether any two products are "directly competitive or substitutable".

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

7.17 There have been two relatively recent disputes dealing with taxes on alcoholic beverages, *Japan – Taxes on Alcoholic Beverages II* and *Korea – Taxes on Alcoholic Beverages*. The findings in these two cases can offer, in our view, instructive guidance on the determination of the various questions at issue in this dispute. However, we are mindful of the statement of the Appellate Body in *Japan – Taxes on Alcoholic Beverages II*, that these disputes must be determined on a case-by-case basis taking into account the conditions prevailing in the particular market at issue.

7.18 Consequently, we will draw guidance from the general analyses used in these two earlier cases, among others, but the determination of the central question whether the two categories of products are directly competitive or substitutable will be based on the facts and circumstances prevailing in this case.

7.19 The definition of "like" products is narrow for purposes of Article III:2. The definition of "directly competitive or substitutable" products is broader. The question is how much broader. In

³⁵⁵ Appellate Body Report on *Japan – Taxes on Alcoholic Beverages II*, *supra.*, p. 25.

³⁵⁶ Panel Report on *Japan - Taxes on Alcoholic Beverages*, adopted on 1 November 1996, WT/DS8/R, WT/DS10/R, WT/DS11/R, para. 6.28, citing Working Party on Border Tax Adjustments, para. 18.

³⁵⁷ *Ibid.*, citing the Panel Report on *Japan – Customs Duties, Taxes and Labelling Practices on Imported Wines and Alcoholic Beverages*, BISD 34S/83 (hereafter, "*Japan – Taxes on Alcoholic Beverages I*").

this regard, we note the analysis of the panel in *Korea – Taxes on Alcoholic Beverages* concerning the negotiating history of Article III:2, second sentence. That panel stated:

Article 32 of the Vienna Convention provides that it is appropriate to refer to the negotiating history of a treaty provision in order to confirm the meaning of the terms as interpreted pursuant to the application of Article 31. A review of the negotiating history of Article III:2, second sentence and the *Ad Article III* language confirms that the product categories should not be so narrowly construed as to defeat the purpose of the anti-discrimination language informing the interpretation of Article III. The Geneva session of the Preparatory Committee provided an explanation of the language of the second sentence by noting that apples and oranges could be directly competitive or substitutable. Other examples provided were domestic linseed oil and imported tung oil and domestic synthetic rubber and imported natural rubber. There was discussion of whether such products as tramways and busses or coal and fuel oil could be considered as categories of directly competitive or substitutable products. There was some disagreement with respect to these products.³⁵⁸

2. Evidentiary matters

(a) Potential competition

7.20 The European Communities submitted that Article III:2, second sentence, is concerned not only with tax differentials between products that are actually competitive or substitutable in a given market, but also with tax differentials between products that are potentially competitive or substitutable. The European Communities further argued that the notion of potential competition must be deemed to include not only competition that would exist "but for" the tax measures at issue, but also competition that could reasonably be expected to develop in the near future.³⁵⁹

7.21 It is well established in GATT jurisprudence, that Article III does not protect export volumes but, instead, protects competitive opportunities. In this regard the Appellate Body stated in *Japan – Taxes on Alcoholic Beverages II* that:

[I]t 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.³⁶⁰

7.22 We agree with the panel in *Korea – Taxes on Alcoholic Beverages* (which reasoning was upheld by the Appellate Body)³⁶¹ when it stated that:

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 future based on the evidence presented. How much weight we will give to 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 scope of the inferences to be drawn. If one is dealing with products that are experience based consumer

³⁵⁸ Panel Report on *Korea – Taxes on Alcoholic Beverages*, *supra.*, para. 10.38, citing EPCT/A/PV/9, p.7; E/Conf.2/C.3/SR.11,p.1 and Corr.2; and E/Conf.2/C.3/SR.40, p.2.

³⁵⁹ See EC First Submission at para. 102. We note that Chile did not address this issue.

³⁶⁰ Appellate Body Report on *Japan – Taxes on Alcoholic Beverages II*, *supra.*, p.16.

³⁶¹ Appellate Body Report on *Korea – Taxes on Alcoholic Beverages*, *supra.*, paras. 112- 124.

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.³⁶²

7.23 The Appellate Body further explained in its Findings in that case that:

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 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.³⁶³

7.24 We agree that panels should look at evidence of trends and changes in consumption patterns and make an assessment as to whether such trends and patterns lead to the conclusion that the products in question are either directly competitive or substitutable now or can reasonably be expected to become directly competitive or substitutable in the near future.

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

(b) Product categories

7.26 The European Communities submitted that all pisco must be considered as a single product for the purposes of the determination whether it is directly competitive or substitutable with imported distilled spirits. The European Communities argued that the four varieties of pisco are distinguished solely in terms of alcoholic strength, and as such the difference does not warrant treating each of them as a distinct product for the purposes of Article III:2, second sentence since there is no correlation between the alcoholic strength of pisco and its quality/price.

7.27 The Appellate Body is of the view that the grouping of products is "a practical device to minimise repetition when examining the competitive relationship between a large number of differing products."³⁶⁴ The Appellate Body has gone further to state that whether, and to what extent, products can be grouped is a question to be determined on a case-by-case basis.³⁶⁵ In determining this question, a panel has to take into account the components of the products that are being grouped to determine whether there is enough similarity to warrant their being grouped together, notwithstanding some variation in composition, quality, function or price.³⁶⁶

7.28 In the case before us Chile did not argue that the various types of pisco constituted different products for either analytical purposes or for determining whether the imports and pisco were directly competitive or substitutable. The European Communities also argued that the appropriate category of

³⁶² Panel Report on *Korea – Taxes on Alcoholic Beverages*, *supra.*, para. 10.50.

³⁶³ Appellate Body Report on *Korea – Taxes on Alcoholic Beverages*, *supra.*, para. 120.

³⁶⁴ *Ibid.*, para. 142.

³⁶⁵ *Ibid.*, para. 143.

³⁶⁶ *Ibid.*, para. 142.

imported products for consideration is all distilled alcoholic beverages identified in HS 2208 as described in the request for establishment of a panel. Chile has not made any arguments to the contrary. This is the category of imported products identified as appropriate by the Appellate Body in *Japan – Taxes on Alcoholic Beverages II*. To take as the appropriate grouping of imports all products contained in HS 2208 does not, in this case, prejudge the matter as the panel and Appellate Body were concerned *might* happen in *Korea – Taxes on Alcoholic Beverages*. This is because, in effect, Chile argued that the whole category of pisco is sufficiently distinct from all other distilled alcoholic beverages that this is the proper basis for comparison with respect to the analysis of the issue of directly competitive or substitutable. Under Chilean law pisco is an appellation of origin referring to spirits made from grapes grown in a particular region of Chile. Thus pisco is exclusively a domestic product and reference to imports identified by HS 2208 does not include pisco. "Pre-judgment" is not an issue in this case.

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

3. Product comparisons

(a) General

7.30 The next step is to consider the various attributes of the products at issue to determine whether these attributes support a conclusion that there is a directly competitive or substitutable relationship between the imported and domestic products. In this regard, we will examine the end-uses of the products, their physical characteristics, the channels of distribution, price relationships (including cross-price elasticities), and other relevant characteristics.³⁶⁷

(b) End-uses

7.31 Overlap in end-use determines to a great extent direct competitiveness or substitutability. The Appellate Body in *Japan – Taxes on Alcoholic Beverages II* specifically agreed with the panel finding to the effect that:

[T]he decisive criterion in order to determine whether two products are directly competitive or substitutable is whether they have common end-uses, *inter-alia*, as shown by elasticity of substitution.³⁶⁸

7.32 In other words, the overall inquiry focuses on whether there are common end-uses by examining a number of factors which can include elasticity of substitution. It is worth examining the extent of the current overlap of the end-uses as well as the appropriate definition of what a common end-use is for purposes of this inquiry. The current overlap of end-uses can be limited due to, *inter alia*, the very measures at issue, protective tariffs, resulting low volumes and high sales costs or other factors. It is also possible that the inquiry in some cases can include an examination of other relevant markets than the one in question to see if there is evidence of common end-uses of the products and take that into consideration.

³⁶⁷ These are the criteria we have examined in this case. There may be other criteria more or less relevant in other situations depending on the facts available.

³⁶⁸ Appellate Body Report on *Japan – Taxes on Alcoholic Beverages II*, *supra.*, p. 25, quoting the Panel Report, para. 6.22.

7.33 In this regard, it is worth noting that the panel in *Korea – Taxes on Alcoholic Beverages* observed that:

End-uses constitute one factor which is particularly relevant to the issue of *potential* competition or substitutability. If there are common end-uses, then two products may very well be competitive, either immediately or in the near and reasonably predictable future.³⁶⁹

7.34 The European Communities asserts that pisco and the imported distilled spirits are already used by Chilean consumers for similar end-uses. The European Communities refer to a market research done on the drinking habits of a representative sample of consumers.³⁷⁰ The European Communities argues that on the basis of the 1997 SM Survey, pisco and the imported distilled spirits are consumed in the same way (straight, diluted with water, ice, soft drinks or fruit juice, and in cocktails). The European Communities thus argues that there is a substantial overlap of end-use between whisky and pisco, the two spirits which Chile emphasises as being the most different.

7.35 Chile raises questions on the probative value of the consumer surveys being relied on by the European Communities. With respect to the discussion of end-uses, Chile disagrees with the results of the 1997 SM survey. In Chile's view, questions that ask consumers what they would choose if their preferred spirit were unavailable can only lead to abnormal and unpredictable answers. Chile also points out that the data in the 1998 SM Survey³⁷¹ is a purported quantitative analysis, in which consumers were faced with a hypothetical change in the prices of whisky, pisco and other spirits, the results of which can only be misleading.

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

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

7.38 The parties disagreed over the appropriate breadth of categories of end-uses. The European Communities' position is that if two spirits have similar end-uses, it is a factor tending to show that the two products are directly competitive or substitutable. On the other hand, Chile asserts that similar end-uses are common features applicable to every alcoholic beverage without being in any way determinative of the question of direct competitiveness or substitutability.

7.39 In our view, the 1997 SM Survey provides some useful evidence about overlapping end-uses. It tends to confirm the observation that distilled alcoholic beverages are used for relaxation and socialisation in appropriate social settings. Chile's rebuttal largely turns on the observation that the

³⁶⁹ Panel Report on *Korea – Taxes on Alcoholic Beverages*, *supra.*, para. 10.78.

³⁷⁰ Comprehensive survey done by Search Marketing S.A., Santiago, December 1997 ("the 1997 SM Survey"), EC Exhibit 21. *See also* the 1998 SM Survey (EC Exhibit 22) discussed more fully below.

³⁷¹ *See* Table 23 in Descriptive Part of this Report.

evidence submitted by the European Communities proves too much due to the broad nature of the proposed categories of end-uses. Indeed, it may very well be that beer and wine can be used for some of the same purposes and may very well share some of the same end-uses as distilled alcoholic beverages. Beer and wine might be directly competitive or substitutable with some or all distilled alcoholic beverages in the Chilean market, but that is not the subject of our inquiry. Moreover, that does not detract from the probativeness of the evidence in regard to the substitutability of distilled alcoholic beverages.

7.40 We note that, while we find the 1997 SM Survey useful, we do not rely on this single piece of evidence for our analysis. Rather, in the process of weighing all the evidence presented, we take the 1997 SM Survey into consideration in determining whether the imported and domestic distilled alcoholic beverages are directly competitive or substitutable. That some portions of the survey are broad and *if* applied to other non-distilled alcoholic beverages *might* also show overlap of end-uses, does not mean that the survey is irrelevant to our inquiry. To put it another way, it may be that distilled alcoholic beverages are a subset of a broader category of directly competitive or substitutable products (and we make no findings in that regard), but that does not lead to the conclusion that the subset at issue here is not made up of directly competitive or substitutable products.

7.41 We also note that there was a survey produced by the Adimark company (the "Adimark Survey") for the Chilean industry and provided to the Chilean legislature during its deliberations on changing the tax system for distilled alcoholic beverages. This survey was based on a very limited number of persons, but persons who were chosen presumably quite carefully to be representative of specific categories of Chilean customers. According to the survey, certain categories of consumers found whisky and pisco quite substitutable and would shift consumption to whisky in favorable price conditions which could result from tax equalisation. This was particularly pronounced for young consumers. Another category showed a willingness to increase whisky consumption initially in response to these price changes, but could return more to pisco over the long run because of its identification as a traditional Chilean drink.

7.42 While we note the limited nature of the samples in this study, it confirms and highlights the data and conclusions of other evidence such as the 1997 and 1998 SM Surveys. There appears to be no question that pisco is identified as the traditional drink of Chile. It is probable that pisco will retain such identity regardless of the tax structure. However, the argument becomes tautological if it should be claimed that pisco is the traditional drink and is, therefore, perceived somewhat differently so that it may receive favorable tax treatment based on its character as a traditional drink. This would amount to a difference in perception that is reinforced by the tax system and then used as justification to maintain the favourable tax treatment itself.

7.43 Products do not have to be substitutable for all purpose at all times to be considered competitive. It is sufficient that there is a pattern that they may be substituted for some purposes at some times by some consumers. The Adimark Survey shows this. It is not extensive enough to show the extent of such willingness, but we note that it was based on representative groups. The Adimark Survey shows the price sensitivity of the demand for the product. There is an increased willingness to try imports as the price changes in a manner reflective of tax equalization. The Adimark Survey also shows the nature of alcoholic beverages as an experience good. The sections of Chilean society most reluctant to switch from pisco to imports is the group with least exposure to such products. They show a willingness to try imports if available at lower prices, but think they would go back to pisco in the long run. Those with the greatest experience already with imports showed the willingness to switch more readily. Furthermore, the Adimark survey shows the nature of the consumption decisions at issue here. Distilled alcoholic beverages are products with low prices relative to income, and therefore it is relatively easy to switch consumption to another product for a portion of needs and still maintain loyalty to familiar brands on a broader basis. There can be some level of substitution

without fundamental changes in consumption patterns such as might be required with respect to high priced consumer durables.

7.44 We do not wish to over-emphasise the Adimark Survey. It is useful evidence, particularly given that it was produced for use by the legislature and not commissioned strictly for the purposes of this dispute, and that it was based on representative samples of Chilean society. It is consistent with other evidence.

7.45 As the Appellate Body has noted, Article III cases deal with markets.³⁷² The panel in *Korea – Taxes on Alcoholic Beverages* noted the usefulness of examining marketing strategies in determining whether products are substitutable.³⁷³ Marketing strategies that highlight fundamental product distinctions or, alternatively, underlying similarities may be useful tools for analysis.

7.46 The evidence of trends towards increasing overlap in end-uses is supported by the marketing strategies of the domestic Chilean companies. These companies met the threat of imports of distilled alcoholic beverages by, among other things, creating and selling premium pisco, which is more expensive than ordinary pisco and is usually colourfully presented as an up-market distilled spirit generally having an alcohol content comparable to whisky, cognac or up-market brandy. The complainants also produced evidence that these products were being advertised as competitive with up-market imported distilled spirits.³⁷⁴

7.47 There is evidence that imported spirits and pisco are used similarly in various social settings – homes, bars, discos etc. The advertising of pisco indicates to consumers that it is suitable as an up-market distilled spirit which shows that the intention by the producers is to put it in the same competitive category with such up-market imports as whisky, cognac, brandy, etc. The various surveys reviewed also show that consumers have an increased willingness to shift between domestic and imported spirits for at least some purchases and some occasions. The current actual overlap in end-uses plus the evidence of potential overlap, is supportive of a conclusion that pisco and the imported distilled spirits are directly competitive or substitutable.³⁷⁵

(c) Physical characteristics

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

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

³⁷² Appellate Body Report on *Japan – Taxes on Alcoholic Beverages II*, *supra.*, p. 25.

³⁷³ Panel Report on *Korea – Taxes on Alcoholic Beverages*, *supra.*, para. 10.95.

³⁷⁴ See EC Exhibit 51, Control's Recipe Brochure, EC Exhibit 52, Capel's Internet home page & Exhibit 54, Capel's advertising brochure.

³⁷⁵ We note that these conclusions with respect to end-uses support our conclusion that the identified imported products should be considered as a single category.

7.50 Chile's response is that pisco and the imported distilled spirits share virtually no common physical characteristic other than containing alcohol and water. According to Chile, the ingredients of pisco and say, whisky, are markedly different. Chile points out these two spirits are made from different ingredients, pisco from grapes and whisky from grain. Chile further argues that the basic similarities the European Communities refers to are mere characteristics of all distilled spirits and that the ultimate physical characteristics, which consumers use to distinguish between different types of spirits, are determined by the other processes involved in the production of spirits.

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

"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 products are "like".³⁷⁶

7.52 Consequently, if two products are nearly physically identical, they are "like".³⁷⁷ Because it necessarily follows that they are also then directly competitive or substitutable, physical similarity is a useful category of examination for our analysis in this case. This is relevant where such activities as marketing campaigns or government tax regimes, have created a distinction in consumer perceptions between very similar products. Such distinctions that result from consumer perception are relevant but not determinative of the *nature* of an actual or potential competitive relationship.

7.53 These physical similarities are relevant to the inquiry, particularly with respect to potential competition. We regard the aspect of a product being a potable distilled spirit with a high alcohol content as an important defining characteristic.³⁷⁸ We note that all the products presented to the Panel have this significant common feature.

7.54 In our view, the post-distillation differences due to the filtration, colouring or aging processes of the beverages are not so important as to render the products non-substitutable.³⁷⁹ We find these differences relatively minor. There are some differences imparted from such things as aging in wooden barrels. Some spirits have added flavourings such as juniper berries in gin. But we also note that pisco shares many identical physical characteristics with other spirits made from grapes such as grappa, cognac, brandy or "Peruvian pisco".³⁸⁰ Overall, weighing the evidence presented, we find that the common physical features of the imported and domestic products are supportive of a finding that the imported and domestic products in question are directly competitive or substitutable.³⁸¹

³⁷⁶ Appellate Body Report on *Korea – Taxes on Alcoholic Beverages*, *supra.*, para. 118.

³⁷⁷ Panel Report on *Japan – Taxes on Alcoholic Beverages II*, *supra.*, para. 6.22.

³⁷⁸ We note that alcoholic beverages containing only fermented ingredients cannot achieve as high a concentration of alcohol as is possible through the distillation process.

³⁷⁹ See Tables 7 and 8 of the Descriptive Part of this Report. Indeed the panel in *Korea – Taxes on Alcoholic Beverages* found that post-distillation differences between soju and imported spirits at issue in that case were relatively minor compared to the common feature of being potable distilled spirits. Panel Report on *Korea – Taxes on Alcoholic Beverages*, *supra.*, para. 10.67.

³⁸⁰ We note that the product labelled pisco by Peru is not allowed to use that appellation in Chile. Peru claims that it has a disagreement with Chile over who has rights to the appellation. That question is outside our terms of reference and we take no position on it and no implication should be drawn from our use of the term "Peruvian pisco."

³⁸¹ We note that these conclusions with respect to physical characteristics support our conclusion that the identified imported products should be considered as a single category.

(d) Channels of distribution and points of sale

7.55 The European Communities argues that the 1997 SM Survey shows that all types of premises market both pisco and the imported distilled spirits together. For both categories, the preferred outlets are the same, supermarkets and liquor stores. The European Communities also argue that their presentation in the retail outlets in the same shelf space is evidence of their substitutability.

7.56 Chile does not dispute the factual assertion that pisco and imported distilled spirits are sold in the same sales channels and can even share shelf space, but does not agree that this is evidence of substitutability. According to Chile, such an argument is as unreasonable as an assertion that toothpaste and soap are substitutable because they are sold in the same channels and share shelf space. Chile also presented evidence showing that imports, and not pisco, are more likely to be distributed in supermarkets than pisco, while pisco is more commonly available in traditional stores.

7.57 The Panel in *Korea – Taxes on Alcoholic Beverages* noted that:

[C]onsiderable evidence of overlap in channels of distribution and points of sale....is supportive of a finding that the identified imported and domestic products are directly competitive or substitutable.³⁸²

We agree with that panel's finding on this point. In the case before us, there is no dispute that the two categories of distilled spirits are sold in similar sales channels, albeit arguably in somewhat different proportions, and indeed actually share shelf space. Chile has pointed out that many products share shelf space, but cannot be considered substitutable because of that. That is of course true. However, the *consistent* practice of putting these products on adjoining shelf space in similar outlets is *one* piece of evidence supporting a finding of substitutability. If it is a coincidence that products happen to be next to each other on shelves, one would not expect it to be repeated consistently.

7.58 It is also the case that complementary products are often grouped together to help in their marketing. However, as revealed in our discussion of overlapping end-uses above, we find no evidence that pisco and the imports are considered as complements by consumers in the way, in Chile's example, soap and toothpaste might be.

7.59 In our view, if products have quite distinct channels of distribution that could be a negative indicator with respect to substitutability. For example, if the products were regularly presented separately, it would be *one* piece of evidence that perhaps consumers did not group them together in their perceptions. In our view, the facts before us indicate an overall pattern of use of channels of distribution, including the presentation of the products within those channels, that is supportive of a finding that the domestic and imported products are directly competitive or substitutable.³⁸³

(e) Prices

7.60 The European Communities submitted that the consumer survey in the 1998 SM Survey³⁸⁴ shows that factors that have a direct impact on the prices of other spirits but not on the price of pisco itself, affect the demand for pisco, which shows a directly competitive or substitutable relationship between pisco and those other spirits. According to the European Communities, the survey measured respondent's reaction to changes in the relative price of pisco and the other distilled spirits, and their response indicates a significant degree of cross-price elasticity between pisco and other spirits. In

³⁸² Panel Report on *Korea – Taxes on Alcoholic Beverages*, para. 10.86.

³⁸³ These conclusions with respect to channels of distribution and points of sale support our conclusions that the identified imported products should be considered as a single category.

³⁸⁴ EC Exhibit 22.

such a scenario, the share of respondents choosing whisky and other spirits instead of pisco would increase from 17.7% to 30.5%.³⁸⁵

7.61 The European Communities further argues that the survey showed that pisco consumers, by an overwhelming majority (70%), would opt for other spirits if pisco was unavailable, and only 17% would opt for wine or beer.³⁸⁶

7.62 The European Communities asserts that the 1998 SM Survey shows the immediate reaction of consumers to price changes. Bearing in mind that the consumption of distilled spirits is based on habit, which changes very gradually, short-term elasticities are bound to be much lower than long-term elasticities. What this means, according to the European Communities, is that over a period of time, the price changes resulting from the elimination of tax differentials are likely to lead to a shift in consumption from pisco to other spirits by a larger degree.

7.63 To back up their claims on cross-price elasticity, the European Communities submitted a study conducted on the Chilean distilled spirits market in 1995 by the Gemines consulting group.³⁸⁷ Chile also submitted a separate study with respect to the cross-price elasticity of pisco and imported distilled spirits.³⁸⁸ We note at the outset, that both this study and the Chilean data lack a model incorporating the supply side, and as such all the variation in the data is interpreted as movements along, or shifts of, the demand curve.

7.64 We also note that the studies relied on by both parties rely on small samples. In the case of the Chilean data, the number of observations is particularly low. In the case of the 1995 Gemines study, it lacks data for the key independent variable, the price of whisky, for almost half the sample period. For these reasons we treat these studies with caution.

7.65 The European Communities argues that the 1995 Gemines study, which was actually done for the Chilean pisco industry, provides further evidence of significant cross-price elasticity between pisco and whisky. The European Communities notes that the Gemines study, which estimated the cross-price elasticity between pisco and whisky on the basis of historical sales and price data in the period 1985-92, found a cross-elasticity rate between pisco and whisky of 0.26%, indicating that if the price of whisky went up by 10%, the sales volume of pisco would increase by 2.6%. The European Communities point out that the Gemines study found that on this basis, pisco and whisky are "substitutes albeit to a limited extent".³⁸⁹

7.66 The European Communities states that another Gemines study done in 1996, whose findings were widely published, concluded that a reduction in the tax on whisky by 50% would lead to a 47% drop in the price of whisky, which would in turn lead to a 17% drop in the demand for pisco.³⁹⁰

³⁸⁵ See EC First Submission, Table 19.

³⁸⁶ Ibid., Table 17.

³⁸⁷ *The Possible Effects on the Pisco Industry of a Reduction in the Tax on Whisky*, Gemines, August 1995 (the 1995 "Gemines Study"). This study apparently was commissioned by the Chilean pisco industry.

³⁸⁸ See Annex II, Chile First Submission.

³⁸⁹ 1995 Gemines study, p.61, EC Exhibit 20.

³⁹⁰ 1996 Gemines study, as reported in *El Diario*, 2 July 1996, EC Exhibit 30. This evidence submitted by the European Communities indicating a significant cross-price elasticity is all the information we have about this report. We note that Chile was requested to submit a copy of this report. Chile was unable to do so. According to Chile, the study is the property of the pisco industry which refused to make it available due to alleged flaws in the results as well as confidential business information contained therein. Chile argues that neither it nor its industry is compelled to submit such information. We find the decision of Chile and its industry regrettable. Confidential business information can be protected. If there are alleged flaws in an

7.67 Chile points out that the EC's main evidence, 1998 SM survey, shows a remarkable lack of reliability. For instance, in the case of whisky, Chile argues that a more detailed analysis shows that whisky has a price elasticity of negative 5, meaning that a 10% reduction in price will lead to a 50% increase in volume, a result which is, according to Chile, completely out of range.³⁹¹ Chile further argues that the elasticities on the other spirits do not deserve any comment because of their unrealistic results. We note, however, that the surveyors compared the envisaged reaction of the survey respondents to preferences expressed after the prices of pisco, whisky, and "other spirits", have changed in response to a hypothetical situation of a tax of 27% *ad valorem* being applied uniformly to all distilled spirits. Elasticity of substitution is a "partial concept" in that it is a measure of the relationship between one quantity and one price and assumes that all other factors are held constant. For example, a cross-price elasticity measurement could hold the price of pisco constant, decrease the price of whisky and determine the changes in quantity of pisco. In this study, because prices change simultaneously, the outcome of changes in the quantity demanded do not allow the accurate computation of either own-price or cross-price elasticities since the other explanatory variables did not remain unchanged (i.e., the *ceteris paribus* requirement in this type of analysis has not been provided for, and partial derivatives have not been determined).

7.68 The question arises, as to how a panel should deal with concepts such as cross-price elasticity in determining whether two classes of products are directly competitive or substitutable. In *Japan – Taxes on Alcoholic Beverages II*, the Appellate Body affirmed the decision of the panel to look at the economic concept of "substitution" as one means of examining relevant markets. However, the Appellate Body emphasised that this should be considered together with all other legitimate considerations, in the aggregate, in determining direct competitiveness and substitutability, i.e., the use of cross-price elasticity of demand is not the decisive criterion, but merely one among other criteria, such as physical characteristics, common end-uses, etc.³⁹²

7.69 The Panel wishes to emphasise that the concept of substitution in markets should not be confused or equated with a numerical measurement of the extent of substitution as found in the coefficient of cross-elasticity. The existence of substitution between pisco and imported distilled beverages lies at the heart of this dispute and is the fundamental issue in light of both the treaty text and in terms of analytical approach. However, the econometric measurement of the degree of substitution may not, partly for the reasons discussed below, always adequately reflect the extent of substitution.

7.70 A high coefficient of cross-price elasticity would of course lend more credence to a claim of direct competitiveness or substitutability, although a low coefficient of cross-price elasticity is not necessarily fatal to a claim of direct competitiveness or substitutability. Indeed, a low coefficient of

otherwise relevant study, the party can submit comments in that regard. Chile has done so with respect to the 1995 Gemines study which was also a study commissioned by the Chilean industry. It is true that there is no compulsory discovery process in WTO dispute settlement proceedings. However, the overall dispute settlement process cannot work fairly and efficiently either at the consultation or panel stage if relevant evidence is withheld. In this case, the Chilean pisco industry decided to withhold this evidence. While it is the Chilean government which is party to this case, it would be unrealistic and artificial to argue that the panel should not address the issue based on this distinction given the direct underlying economic interest of the Chilean industry. Thus, Chile did not avail itself of the opportunity to rebut the evidence presented by the European Community. (See also the Panel Report on *Indonesia – Certain Measures Affecting the Automobile Industry*, adopted on 23 July 1998, WT/DS54, WT/DS55, WT/DS59, WT/DS64, paras. 14.230-14.235. We note that this case involved the failure of a *complainant's* industry to submit evidence supporting complainant's case, but we agree generally with the point that parties and their industries should not be able to withhold relevant evidence and expect panels to view it favourably.)

³⁹¹ See Chilean Statement at Second Meeting at pp. 12-14.

³⁹² Appellate Body Report on *Japan – Taxes on Alcoholic Beverages II*, *supra.*, p.25.

cross-price elasticity may be due to the very measures in question in the dispute. In this regard, the Appellate Body stated that:

[A] tax system that discriminates against imports has the consequence of creating and even freezing preferences for domestic goods. In the Panel's view, this meant that the consumer surveys in a country with such a tax system would likely understate the degree of potential competitiveness between substitutable products.³⁹³

7.71 It is our view that in general economic terms, a high estimated coefficient of elasticity would be important evidence to demonstrate that products are directly competitive or substitutable provided that the quality of the statistical analysis is high. In this case, in the 1995 Gemines study, for example, a cross-price elasticity of demand for pisco with respect to whisky of 0.26 was obtained, which is low (a 10% rise in the price of whisky will lead to an increase of only 2.6% in the demand for pisco). Nonetheless, we accept this as evidence of substitutability, recognising that some of the other factors discussed below are also indirectly influenced by the price of whisky and may have an impact on the market. We continue to recognise the above-mentioned need for caution in light of concerns about the quality of a particular statistical study.

7.72 Customs, traditions and consumer preferences embodied in brand loyalties could render demand less sensitive in the short run to changes in price and income than would otherwise be expected. It has been noted that alcoholic beverages are "experience goods" for which demand changes only slowly as consumers become gradually more familiar with new products.³⁹⁴ We also think that the estimated elasticity would have been higher, had whisky been less expensive and we note that the whisky imported into Chile tends to be at the higher end of the price range for distilled spirits generally. Whisky is taxed at a much higher rate than pisco and we also note that tariffs on imported spirits were high for a long period of time. These factors, which include the very measures at issue here, can have a noticeable impact on the price of the imports, both directly and indirectly. For instance, the tax and tariff structure can change product offerings towards more expensive items and partly as a result, increase other costs such as distribution. If the retail price of whisky were lower than what it is now, or other normally lower priced products were readily available in a neutral tax setting, it is not unreasonable to expect based on the information before the panel that new customer groups could be attracted and the actual cross-price elasticity would be higher than the current estimates.³⁹⁵

7.73 All these factors point to the logic in the Appellate Body's reasoning in the *Japan – Taxes on Alcoholic Beverages II* case, that undue weight should not be placed on estimated price-elasticity, demand-elasticity or cross-price elasticity. Studies that attempt to measure the relationship between dependent and independent variables and are only part of the totality of factors a panel should take into account in determining the question of direct competitiveness or substitutability.³⁹⁶

7.74 As we have already noted, Chileans consider pisco as a traditional or national drink. We further noted that this does not mean that pisco cannot be substituted for at any time and at any

³⁹³ Panel Report on *Japan – Taxes on Alcoholic Beverages II*, *supra*, para. 6.28, citing Panel Report on *Japan – Taxes on Alcoholic Beverages I*, *supra*, para. 5.9.

³⁹⁴ Appellate Body Report on *Korea – Taxes on Alcoholic Beverages*, *supra*, para. 123 citing the Panel Report on *Korea on Alcoholic Beverages*, paras. 10.44, 10.50 and 10.73.

³⁹⁵ The Panel in *Japan – Taxes on Alcoholic Beverages II* specifically noted that calculated cross-price elasticities in cases such as these will generally underestimate the actual degree of substitutability. Panel Report on *Japan – Taxes on Alcoholic Beverages II*, paras. 6.28 and 6.31. This was expressly approved by the Appellate Body in that case and reiterated in the Appellate Body decision in *Korea – Taxes on Alcoholic Beverages*. Appellate Body Report on *Korea – Taxes on Alcoholic Beverages*, *supra*, para. 120.

³⁹⁶ See Appellate Body Report in *Japan – Taxes on Alcoholic Beverages II*, *supra*, p. 25 and Appellate Body Report on *Korea – Taxes on Alcoholic Beverages*, *supra*, paras. 120-123 and 134.

occasion. In this regard, we note that Chile submitted that pisco, in any of its categories, has a pre-tax price that is substantially lower than whisky, and that consequently taxation has no real effect on retail prices.³⁹⁷ We also note the EC response that Chile is comparing the price of a relatively expensive brand of whisky such as Johnnie Walker, with an inexpensive brand of pisco. The European Communities also points out that the differences in prices between different varieties of pisco can be as large as differences between prices of a particular variety of pisco and say, whisky.

7.75 We agree with the European Communities on the question of price differences between pisco and imported distilled spirits. From the evidence before us, it is clear that one cannot speak of a price difference between pisco and *all* imported distilled spirits. The price differences are only relative, depending on which variety of pisco is being compared with which imported distilled spirit. To assert that all pisco is within a certain price range and all imported spirits in another price range is to go against the weight of evidence.³⁹⁸ What is important is the effect of relative price movements, since it is relative prices and their changes that influence consumer behaviour in the dynamic situation of changes in the demand for directly competitive or substitutable products.³⁹⁹

7.76 It is, therefore, arguable that the retail price levels of imported distilled spirits, such as whisky, could have been influenced by the taxes at issue in this dispute. Despite this, as we have noted, there is some degree of cross-price elasticity between pisco and the imported distilled spirits including whisky (which as we have earlier noted, Chile finds most difficult to envisage being substitutable with pisco).

7.77 As we noted, earlier cases have stated that the *concept* of cross-price elasticity is a strong indicator of substitutability. As we also observed above, a low *estimated* coefficient, as determined in the study submitted by the European Communities and the data from Chile, is not in itself conclusive that substitutability does not exist. We further note that studies that measure elasticity applied to historical data may reveal little about the *potential* for substitution and competition.

7.78 In the case before us, we find it significant that the studies indicate some degree of cross-price elasticity, indicating a potential for substitutability. The level of the elasticity may be a function of actual retail price levels, which could be influenced by taxation and other factors such as past measures, including tariffs, as well as higher distribution costs and other factors resulting from lower volumes.⁴⁰⁰ In our view, therefore, the evidence presented by the data in the various studies and surveys is supportive of the other factors in arriving at a determination that pisco and the imported distilled spirits are directly competitive or substitutable. In this regard, we agree with the panel in *Korea – Taxes on Alcoholic Beverages* when it stated that:

[T]he question is not of the degree of competitive overlap, but its nature. Is there a competitive relationship and is it direct? It is for this reason, among others, that quantitative studies of cross-price elasticity are relevant, but not exclusive or even decisive in nature.⁴⁰¹

³⁹⁷ Table I, Annex I, Chile First Submission.

³⁹⁸ We also note that there are other distilled spirits imported into Chile in relatively smaller quantities that are often sold at lower prices than many brands of whisky. We also note the EC's argument that small import volumes, due in part to the tax differentials, can lead to a concentration of imports in higher price categories.

³⁹⁹ See Panel Report on *Korea – Taxes on Alcoholic Beverages*, *supra.*, para. 10.94.

⁴⁰⁰ See Appellate Body Report on *Korea – Taxes on Alcoholic Beverages*, *supra.*, paras. 122-123.

⁴⁰¹ Panel Report on *Korea – Taxes on Alcoholic Beverages*, *supra.*, para. 10.44. See also Appellate Body Report on *Japan – Taxes on Alcoholic Beverages II*, *supra.*, p. 25, and Appellate Body Report on *Korea – Taxes on Alcoholic Beverages*, *supra.*, paras. 120-123 and 134.

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

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

7.80 Substitutability and competitiveness refer to the ability of products that may be dissimilar in some respects to satisfy a particular consumer want. This definition would suggest that "end-use" is a very important indicator of substitution.

7.81 In our view, studies or surveys that reveal the following all serve as evidence of substitutability in end-uses:

- (i) a tendency among consumers to regard products as substitutes in satisfying a particular need;
- (ii) that the nature and content of marketing strategies of producers indicate that they are competing for the expenditure of potential consumers in a particular market segment; and
- (iii) that distribution channels are shared with other goods;

7.82 In evaluating substitutability in end-use, it may be useful in this regard, to refer to an approach in consumer theory which has been gaining ground.⁴⁰² According to the theory, goods are, in the eyes of consumers, never really perceived as commodities that are in themselves direct objects of utility; rather, it is the properties or characteristics of the goods from which utility is derived that are the relevant considerations. It is these characteristics or attributes that yield satisfaction and not the goods as such. Goods may share a common characteristic but may have other characteristics that are qualitatively different, or they may have the same characteristics but in quantitatively different combinations. Substitution possibilities arise because of these shared characteristics. The oft-cited hypothetical textbook example of butter and margarine may be instructive. Butter and milk are both dairy products that share important characteristics that margarine does not have. However, butter and margarine each have combinations of characteristics that make them good substitutes as compliments for bread, which is not the case with milk. The characteristics of butter and margarine can be expressed as physical properties such as spreadability, taste, colour and consistency. These physical characteristics combine to render both products good substitutes as bread complements. The latter represents the end-use of the commodities as determined by their combination of characteristics derived from certain physical characteristics.

7.83 In our view, the same type of reasoning can be applied to the substitutability of pisco and other spirits such as whisky, brandy, cognac, etc. With respect to whisky and pisco, although the two spirits are distilled from different substances, namely barley and grapes respectively, they share the characteristics of being potable liquids with high alcohol content, which is the product of distillation, as well as being receptive to mixing with non-alcoholic beverages. In any event, even the differences in ingredients between whisky and pisco is not sufficient to render these two distilled alcoholic spirits, both of which have a high alcohol content and more or less satisfy a similar need, incapable of being substituted with each other. As for brandy, cognac and some other spirits, we have already noted that the differences in physical characteristics are only post-distillation differences such as colour and smell which are not sufficiently significant to change the basic character of spirits essentially made from grapes or other fruits.

⁴⁰² See Kelvin J. Lancaster, "A New Approach to Consumer Theory", in *Journal of Political Economy*, Vol. LXXIV (April 1966), pp. 132-157.

7.84 We should stress that the complainants did not have to prove that there is a complete overlap in their analysis of substitutability. We take note in this regard, as discussed above, that the negotiators of what became Article III:2, second sentence, considered, *inter alia*, that apples and oranges were directly competitive or substitutable products. Moreover, we take guidance from the earlier panel findings which found that current market conditions may be distorted by government tax and regulatory policies which tend to freeze consumer preferences in favour of the domestic products. We do not agree that there are pre-tax price differences in the present case of such a level as to establish that the products in question are not even potentially competitive. In addition, after-tax price differences are partly a function of the tax system both in direct impact and indirectly through other factors such as product availability and distribution costs.

7.85 The complainants have established that, as between pisco and the imported distilled spirits, there is certainly a degree of current competition and the likelihood of greater competition in future. We also note that the production and marketing decisions of the pisco producers also reflect such a realisation. The evidence submitted⁴⁰³ clearly shows their desire to convey an image of pisco as a drink that competes with the best imported distilled spirits. We believe that when a product is being marketed in ways that suggest that it is in competition with the most up-market imported distilled spirits, this is evidence of at least potential competition with those imports. In addition, evidence of actual or potential competition must be viewed in the context of the fact that consumer habits on consumption of distilled spirits only change gradually over time.⁴⁰⁴ We are of the view that the totality of the evidence presented supports a finding that the imported distilled spirits, and pisco are directly competitive or substitutable.

7.86 We also note that our findings are consistent with a recent opinion of the Chilean Central Preventive Commission⁴⁰⁵ ("the Commission") which, in deciding on a merger between two major pisco producers, stated that:

[T]here are two conditions that must be met for a monopoly to exist:

- (i) Non-availability of substitute products for pisco; and
- (ii) Existence of barriers to entry preventing new pisco growers from entering the market.

With respect to the first condition, the Commission was satisfied that this was not the position in the Chilean market because:

⁴⁰³ See EC Exhibits 50-54.

⁴⁰⁴ Some of the imported products have an extensive history in the marketplace. Whisky, for example, has long been present in the Chilean market and subject to high duties and/or taxes. However, we note that the taxes and duties on whisky were increased substantially in the 1980's, which appeared to result in a substantial and sustained loss of market share.

⁴⁰⁵ In its submission dated 23 November 1998, the European Communities provided some commentary on the Commission paper. Subsequently, Chile argued that the EC had not requested nor been granted permission to file such comments. Chile requested permission to file further comments itself or, in the alternative requested the Panel disregard the EC's comments. The Panel decided not to grant Chile's request for further time for commentary, given that the Commission paper was a document of the Chilean government that was issued 11 days prior to the second substantive meeting of the Panel with the parties. Chile, in fact, did make some comments on the Commission paper at that meeting. We agreed to take into further consideration Chile's alternative request and have decided to grant it. The European Communities did not ask for time to make further comments on the Commission paper and chose to submit its comments in a submission that was explicitly limited by the Panel to commentary on other documents. Accordingly, we will disregard the EC's comments on the Commission paper.

The broad range of substitute products for pisco available in the liquor segment of the alcoholic beverages market should allow a full substitution in view of the "premium" that consumers are willing to pay for the specific features offered by pisco.⁴⁰⁶

The Commission also observed that:

[T]he market for alcoholic beverages is the pertinent market for pisco. This market includes beer, wine and liquor. Specifically, pisco participates in the segment formed by liquor, brandies and distilled liquor, in a particular niche covered by appellation regulations.⁴⁰⁷

Ultimately, the Commission concluded that:

[P]isco faces major competition from other alcoholic beverages, such as wine, beer and whisky, due to the usual practice of drinking pisco diluted with non-alcoholic beverages. *Therefore, in the market for alcoholic beverages,.....there are alternative products which consumers of alcoholic beverages can choose to drink* (emphasis supplied).⁴⁰⁸

7.87 We note that the Commission was dealing with the question of competition from an anti-trust perspective, which generally utilises narrower market definitions than used when analyzing markets pursuant to Article III:2, second sentence.⁴⁰⁹ Consequently, it seems logical that competitive conditions sufficient for defining an appropriate market with respect to anti-trust analysis would *a fortiori* suffice for an Article III analysis. We would, therefore, regard the findings of the Commission as tending to confirm the finding that in the Chilean market, pisco and imported distilled spirits are directly competitive or substitutable products.

7.88 In summary, we are of the view that there is sufficient unrebutted evidence in this case to show both present and potential direct competition between the two categories of products. Accordingly, we find that the evidence concerning physical characteristics, end-uses, channels of distribution and pricing (including cross-price elasticity),⁴¹⁰ leads us to conclude that the imported and domestic products at issue in this case are directly competitive or substitutable.

⁴⁰⁶ Legal Opinion adopted by the Central Preventive Commission, Merger of Pisco-Manufacturing Cooperative Societies CAPEL and Control, Case Record No. 107-97, pp. 4-5.

⁴⁰⁷ *Ibid.*, p. 2.

⁴⁰⁸ *Ibid.*, p. 8.

⁴⁰⁹ The panel in *Korea – Taxes on Alcoholic Beverages* was of the view that the definition of a market in anti-trust is not the same as under Article III. The panel felt that because the two concepts (anti-trust and competitive opportunities under Article III) are designed to address different concerns their definitions of the market need not be the same. According to the panel, since Article III is primarily concerned with competitive opportunities it defines markets more broadly than anti-trust which is designed to protect the actual mechanisms of competition. See Panel Report on *Korea – Taxes on Alcoholic Beverages*, *supra.*, para. 10.81. We agree with that panel's conclusions on the general relationship of the definition of markets in anti-trust cases and under Article III.

⁴¹⁰ The European Communities argued that tariff classification can be important in determining whether products are directly competitive or substitutable. In this case, the European Communities referred to the 4-digit Harmonized System category 2208 as such evidence. Chile responded that 4-digit classifications are too general to be of much analytical use and in some cases contained products which Chile maintained clearly were not substitutable. We note that the Appellate Body and previous panels have referred to the tariff classifications of products in making determinations. However, two issues must be taken into account. First, is the classification sufficiently narrow to be of much probative value? Chile has a valid point in urging caution in this regard. Second, is relying on tariff classifications merely duplicative of examinations made in greater detail for the specific market in question in regard to such factors as physical characteristics and similar end-uses? In

D. "NOT SIMILARLY TAXED"

1. General

7.89 The Appellate Body in *Japan – Taxes on Alcoholic Beverages II* stated that "to be 'not similarly taxed', the tax burden on imported products must be heavier than on 'directly competitive or substitutable' domestic products and that burden must be more than *de minimis* in any given case".⁴¹¹ The Appellate Body noted that this determination must be made on a case-by-case basis.

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

7.91 For some products a very small difference in tax levels could be *de minimis*, a difference that would be too large to be considered *de minimis* for other products. As always in cases such as these, the determination must be based on examination of the market in question, the market of the respondent Member. However, caution must be used because the very taxes in question, as well as other governmental policies, may have had an impact on the market resulting in difficulty determining whether a relatively small level of differentiation is *de minimis* or does indeed have a discernable effect on the market.

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

2. Transitional System

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

7.94 The European Communities argues that these tax differentials are quite large and, even at the lowest differential in the final period of the Transitional System, the rate for whisky (53%) is more than double the rate for pisco (25%). The EC argues that this is more than *de minimis*. The European Communities also argues that pisco will be taxed at a lower rate than the category of "other spirits". The European Communities states that, while the differential is lower than with respect to whisky, it

our view, with respect to the Chilean market, there is not a great amount of probative value in referring to HS 2208 in light of other evidence available, but we note that the classification is consistent with our conclusions.

⁴¹¹ Appellate Body Report on *Japan – Taxes on Alcoholic Beverages II*, *supra.*, p. 27. See also Appellate Body Report on *Canada – Periodicals*, *supra.*, at 29.

is still large enough to be capable of affecting the competitive relationship between the products, citing the 1998 SM survey.

7.95 Chile does not contest the EC's arguments with respect to the Transitional System, relying instead on its arguments that the domestic and imported products are not directly competitive or substitutable.

7.96 It is obvious that the level of difference in taxation between the imported and domestic products is greater than *de minimis*. We note that there is Chilean production of both whisky and other spirits, but by definition there are no imports of pisco. Whisky (imported and domestic) currently is taxed at more than twice the rate of pisco. While this difference will narrow somewhat next year, it clearly will remain more than *de minimis*. With respect to other spirits (again, including both domestic and imported) the difference is five percentage points *ad valorem*. The 1998 SM Survey indicates that such a difference has an impact and is greater than *de minimis*. Chile does not contest the EC's arguments and evidence to the effect that this is greater than *de minimis* in the context of distilled alcoholic beverages in Chile.

7.97 We are of the view that under the Transitional System imported and domestic distilled alcoholic beverages are not similarly taxed. The fact that some of the domestic production (e.g., products such as Chilean whisky) is similarly taxed is irrelevant to this step of the analysis. That is, it is sufficient to find that certain of the imports are taxed dissimilarly compared to certain of the domestic substitutable products. It is not necessary to show that all of the imports are taxed dissimilarly to all of the domestic products.⁴¹²

3. New Chilean System

7.98 The New Chilean system becomes effective on 1 December 2000.⁴¹³ The distinction between types of distilled alcoholic beverages utilised in the Transitional System is eliminated. Instead, the New Chilean System assesses taxes on an *ad valorem* basis that varies according to alcohol content. All distilled alcoholic beverages of 35° of alcohol or less are taxed at the rate of 27% *ad valorem*. The rate increases by four percentage points *ad valorem* per degree of alcohol content through 39°, topping out at a rate of 47% *ad valorem* for alcoholic beverages of higher than 39°.

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

7.100 According to the European Communities, the New Chilean System cannot be considered as a tax on alcohol content, because it is applied on the value of the beverage as a whole and not on the value of the alcohol content. Moreover, the European Communities argues that the value of distilled spirits is not directly related to alcohol content. For those reasons the European Communities considers that, in order to determine whether pisco and the other spirits are "similarly taxed", we should compare the rates per bottle of each spirit. Such *ad valorem* rates are manifestly different varying between 27% and 47% in steps of four percentage points and such differences are clearly not *de minimis*. In the alternative, the European Communities argues that, at any rate, pisco and the other

⁴¹² See Appellate Body Report on *Canada – Periodicals*, *supra.*, p. 29; Panel Report on *Korea – Taxes on Alcoholic Beverages*, *supra.*, para. 10.100 (fn. 412).

⁴¹³ The new Chilean System has been enacted but not implemented. There appears to be no discretion allowed in its enforcement. The law is certain and definitive. We consider it appropriate to examine the law to determine its consistency with Article III:2, second sentence. Neither party has argued to the contrary.

spirits are also "not similarly" taxed when one compares the rates per degree of alcohol. The rates vary from 0.771% per degree of alcohol at the level of 35° of alcohol to 1.175% per degree of alcohol for beverages at 40°, which is a rate of taxation more than 50% higher per degree of alcohol.⁴¹⁴ According to the European Communities, this difference also is more than *de minimis*.

7.101 Chile responds that the New Chilean System is based on objective and neutral factors. In Chile's view, the criterion of alcohol content was recognized by the panel in *Japan – Taxes on Alcoholic Beverages I* as a permissible objective means of taxation. Chile notes that that case involved non-taxable thresholds and taxes applied in a manner not directly proportional to alcohol content and that the panel did not object to either characteristic. In Chile's view, there is no requirement in GATT/WTO jurisprudence for the proposition that tax systems must be directly proportional.

7.102 Chile argued that it has many products in the higher tax ranges of the New Chilean System, including gran pisco and pisco reserve, as well as locally produced brandy, rum, gin, vodka and whisky. Chile also notes that the European Communities produces many spirits that contain 35° alcohol or less. Chile states that according to the EC's arguments, the EC tax structures would also produce dissimilar taxation. According to Chile, it all depends on how one looks at the issue. Specific tax systems are preferential to high priced products, while *ad valorem* tax systems are preferential to low priced products. Chile made extensive arguments with respect to the taxation system of EC member states to show that such systems were not proportional or could be considered discriminatory depending on how they were viewed.

7.103 In our view the question of dissimilar taxation is relatively straightforward. It does not involve judgements about the objectivity of the laws or regulations involved. It does not involve an assessment of who benefits from the tax system. It does not involve an examination of the design, structure or architecture of the law in question. Such inquiries are relevant only to the next step of our analysis; namely, whether any system of dissimilar taxation has been applied so as to afford protection to domestic production. All we are doing at this point is determining whether there is dissimilar taxation of directly competitive or substitutable imported and domestic products. Even if it were to turn out that the large majority of imported products benefited from a particular tax, that would be irrelevant to this stage of the analysis. Our only issue here is to identify whether there is dissimilar taxation.

7.104 We note Chile's references to the panel report in *Japan – Taxes on Alcoholic Beverages I*, but we also note that the method of analysis in that case, as well as in the panel finding in *Japan – Taxes on Alcoholic Beverages II*, was somewhat different from the test utilised now. In those panel reports there was not clear demarcation between the analysis of "dissimilar taxation" and "so as to afford protection". The Appellate Body in *Japan – Taxes on Alcoholic Beverages II* made it clear that panels should review the matter in two distinct steps.⁴¹⁵ Some of the Chilean argumentation with respect to the question of dissimilar taxation is more appropriately considered in the next step of our analysis.

7.105 We do agree with the Chilean observation that tax systems can appear dissimilar depending on how one looks at them. However, we do not think that observation is relevant to our consideration.⁴¹⁶ A tax system based on taxing value is generally considered not to be applying

⁴¹⁴ The European Communities suggests that there is a third typical method of taxation which is based on volume without reference to value or alcohol content. However, this type of taxation is not used in whole or part in the New Chilean System.

⁴¹⁵ See also Appellate Body Report on *Korea – Taxes on Alcoholic Beverages*, *supra.*, para. 107.

⁴¹⁶ If taken further, one could argue that an overall system of indirect taxation provides dissimilar taxation if viewed from the perspective of direct income taxation. Such an observation may not be inaccurate, but it also is largely devoid of meaning.

dissimilar taxation if done on a purely *ad valorem* basis (i.e., a single *ad valorem* rate applied uniformly to all products). The difficulty in evaluating the New Chilean System is that it is not strictly an *ad valorem* system. It applies *ad valorem* rates that vary not just by the value but qualifies the rate by alcohol content.

7.106 With respect to Chile's argument that it is permitted to choose any objective criteria it wishes in formulating its tax system, we make the following observations. First, we note that the justification of "objective criteria" is troublesome in this regard. Some of the arguments on objectivity are, as we stated, relevant to the third step of the analysis, if at all. Second, it is unclear whether any "objective criteria" would suffice even in Chile's proposal. Would it be permissible, for instance, to tax white spirits differently from brown spirits? The color of spirits is a major dividing line in consumer perception of distilled alcoholic beverages and is certainly "objective" in that it is fairly clear into which category a particular beverage would fall. However, use of such "objective criteria" could result in different taxation of, for example, white rum and dark rum, which would be completely arbitrary. Thus it is clear that Chile's reliance on the argument that its system is based on "objective criteria" is not sufficient.

7.107 To argue as Chile does that there is no rule requiring proportionality is rather beside the point. Even utilising the EC's system of expressing the difference of percentage points per degree of alcohol, an evaluation of the nature of the system still involves mixing together two types of criteria. It is not clear that, even if proportional with respect to *some* particular products, assessing an *ad valorem* tax qualified by the additional criterion of alcohol content would result in a *system* of taxation that would survive examination under this step of the analysis. In this case, a statement that the New Chilean System does not assess taxes in a proportional manner is merely another way of stating that it is not really an *ad valorem* system strictly speaking (and certainly is not a specific system).⁴¹⁷

7.108 We reiterate our observation in the section above that a system of taxation which results in non-*de minimis* dissimilar taxation of directly competitive or substitutable products is not in itself inconsistent with Article III:2, second sentence. It is only inconsistent if such a dissimilar system of taxation is applied so as to afford protection to domestic production. We, in fact, agree that a system which mixes criteria, and possibly even one that explicitly treats imported and domestic directly competitive or substitutable (but not "like") products differently, is not necessarily GATT-inconsistent. However, such a system could be found to involve dissimilar taxation and, therefore, require further analysis under the third step.

7.109 Chile has suggested that saying that the New Chilean System involves dissimilar taxation would be condemning luxury tax systems. However, in the context of the products involved in this case, a luxury tax system would be an *ad valorem* tax system that increased rates as the *value* of the

⁴¹⁷ Chile offered as an analogy the example of automobile taxation in Europe. According to Chile, such automobile taxes increase depending on the size or horsepower of the engines. Chile states that this could discriminate against high horsepower imports. Therefore, Chile concludes, the logic of the EC's argument implies that such a system would be inconsistent with the EC's WTO obligations if Chile's system is found to be so. Analogies can be useful analytical tools if they provide relatively simple illustrations of a problem. However, analogies lose their utility to the extent more and more facts need to be provided about the purportedly analogous situation to determine its relevance. With respect to engine power or size based systems of taxing automobiles, we would need to find out more about the competitive relationship of the products in question and structure of the tax system, as well as how it is applied. Again, we note, mere dissimilar taxation alone is not enough to render a tax system inconsistent with the obligations of Article III:2, second sentence. It is also necessary to determine if such a system of dissimilar taxation is applied in a manner so as to afford protection to domestic production. Even then, there may be questions regarding the potential applicability of exceptions pursuant to Article XX. Chile's analogy might or might not be correct, but it would require a whole new fact finding exercise to make such a determination and that clearly is beyond the scope of our terms of reference.

products increased, not as some specific characteristic changed. Thus, for example, a system that assessed taxes at a rate of 20% for products valued between 1000 and 5000 pesos, 30% for products valued between 5,000 and 10,000 pesos, and 40% for products valued above 10,000 pesos and so on might arguably constitute a luxury tax. However, varying the *ad valorem* rate based on alcohol content does not necessarily tax high priced goods at a higher rate because the additional criterion of alcohol content is not necessarily related to value. Therefore, we need not reach the issue of whether luxury tax systems are consistent with the requirements of Article III:2, second sentence.⁴¹⁸

7.110 The difference in taxation between the top (47%) and bottom (27%) levels of *ad valorem* rates of taxation of distilled alcoholic beverages is clearly more than *de minimis* and is so by a very large margin. Indeed, it is obvious that the difference of four percentage points between the various levels of alcohol content also constitutes a greater than *de minimis* level of dissimilar taxation.⁴¹⁹

7.111 Furthermore, if viewed from the perspective of specific taxation the difference of over 50% per degree of alcohol between pisco of 35° (0.771 percentage points per degree of alcohol) and whisky and other imports of 40° (1.175 percentage points per degree of alcohol) is much greater than *de minimis*. We also are of the view that the differential between the individual degrees of alcohol are more than *de minimis*. For instance, spirits of 35° are assessed taxes at 0.771 percentage points per degree of alcohol; spirits of 36° are assessed at 0.861 percentage points per degree of alcohol; and spirits of 37° are assessed at 0.946 percentage points per degree of alcohol. These are significant percentage differences.⁴²⁰

7.112 We also wish to be clear that we are not concluding that any "hybrid" system must result in dissimilar taxation. For one thing, such a broad conclusion would require further examination of the definition of the term "hybrid." For another, it would be beyond our terms of reference. Rather, our finding is that *this* particular system utilised by Chile results in dissimilar taxation that is not *de minimis*.

7.113 As with our finding above with respect to the Transitional System, the fact that some imported and domestic distilled alcoholic beverages could in particular factual circumstances be assessed identical taxes, or different taxes at less than *de minimis* levels, does not change our conclusion.⁴²¹ It is sufficient for this step of the analysis to find that some of the imports are being taxed dissimilarly from some of the domestic production and the difference is more than *de minimis*.

E. "SO AS TO AFFORD PROTECTION TO DOMESTIC PRODUCTION"

1. General

7.114 In its report on *Japan – Taxes on Alcoholic Beverages II*, the Appellate Body stated that:

[The] third inquiry under Article III:2, second sentence, must determine whether "directly competitive or substitutable products" are "not similarly taxed" in a way that affords protection. This is not an issue of intent. It is not necessary for a panel to sort

⁴¹⁸ We also note, that a luxury tax system could be found to result in dissimilar taxation, but still not result in a violation of Article III:2, second sentence, as long as such a system was not applied so as to afford protection to domestic production.

⁴¹⁹ See discussion with respect to Transitional System, above, and results of the 1998 SM Marketing Survey.

⁴²⁰ We also note because of the particular structure of the New Chilean System, the rates decrease from 15° to 35°, increase substantially from 35° to 39° and then begin to decrease above 40°.

⁴²¹ See Appellate Body Report on *Canada – Periodicals*, *supra.*, p. 29. See also Panel Report on *Korea – Taxes on Alcoholic Beverages*, *supra.*, para. 10.100, fn. 412; and Panel Report on *United States – Section 337 of the Tariff Act of 1930*, BISD 36S/345, para. 5.14.

through the many reasons legislators and regulators often have for what they do and weigh the relative significance of those reasons to establish regulatory intent.⁴²²

7.115 The Appellate Body further noted that rather than review the intent of legislators to see whether there was protectionist intent, the real issue was one of "how the measure in question is applied".⁴²³ The Appellate Body went on to explain that the question of application of a measure can be discerned from an examination of the "design, architecture and revealing structure of a measure".⁴²⁴ The Appellate Body further observed that the very magnitude of dissimilar taxation could be evidence of protective application, but there often will be other factors and that panels should give full consideration to all the relevant facts on a case-by-case basis.

7.116 In its report on *Canada – Periodicals*, the Appellate Body provided extensive quotations from a Canadian Minister Designate concerning a Task Force Report which preceded the legislation under examination. There was also a quotation from the Minister of Canadian Heritage during the debate on the legislation to the effect that:

[T]he reality of the situation is that we must protect ourselves against split-runs coming from foreign countries and, in particular, from the United States.⁴²⁵

7.117 The Appellate Body also noted the effect in the market-place that one split-run magazine had pulled out of the Canadian market and that a Canadian-owned split-run magazine had ceased production of its US edition. In light of these various facts, as well as the magnitude of the dissimilar taxation, the Appellate Body concluded that the system of dissimilar taxation was applied in a way that afforded protection to domestic production.

7.118 To a certain extent, this may appear as a change by the Appellate Body in their approach to this part of the analysis of Article III:2, second sentence. However, in its report in *Japan – Taxes on Alcoholic Beverages II*, the Appellate Body stated that the central issue was the design, architecture and revealing structure of the measure. It goes without saying that the stated objectives by the government of the Member concerned may be relevant in evaluating the design of a measure. However, caution must be exercised in doing this for many views can be expressed in open parliamentary debates and this was why the Appellate Body stated that delving into individual legislators' intent is not a useful exercise. Thus, presumably, the Appellate Body was distinguishing between statements by a government and statements by individual legislators.

7.119 Also, it is worth noting the nature of the quotations used in *Canada – Periodicals*. The statements were supportive of a finding of a protective objective and structure of the provision. Statements by a government against WTO interests (e.g., indicating a protective purpose or design) are most probative. Correspondingly, it is less likely that self-serving comments by a government attempting to justify its measure would be particularly probative. To put it another way, dissimilar taxation applied so as to afford protection to domestic production cannot be justified as WTO-consistent because of good intentions. There is no basis for such a justification in the text of GATT 1994.

7.120 Finally in this regard, such statements as referred to by the Appellate Body in *Canada – Periodicals* are really only useful as a factor confirming other evidence. The Appellate Body did not rely just on the statements; rather, account also was taken of the results in the marketplace and the fact of the high level of differential in tax rates between the domestic and imported products.

⁴²² Appellate Body Report on *Japan – Taxes on Alcoholic Beverages II*, *supra.*, p.27.

⁴²³ *Ibid.*, p. 28 (emphasis in the original).

⁴²⁴ *Ibid.*, p. 29.

⁴²⁵ Appellate Body Reports on *Canada – Periodicals*, *supra.*, p. 31.

7.121 The European Communities submitted evidence concerning the Chilean legislative process that led to the adoption of the Transitional System and the New Chilean System. Among other things, the European Communities has alleged that the taxation systems were arrived at as part of an agreement between the Chilean domestic industry and the government. As part of this, the European Communities argues that the pisco industry agreed to sacrifice the high alcohol content versions of pisco in order to preserve the preferential tax treatment of the large majority of pisco production under 35° alcohol content. According to the European Communities, there is no other logical reason why the pisco industry would agree to this increase in taxation of some of its products.

7.122 We do not think it fruitful or appropriate to try to evaluate the Chilean legislative process. As noted above, all sorts of agreements can be made in order to obtain support from a domestic constituent for changes in tax rates. Some may not even have anything to do with the legislation at hand. Furthermore, it is normal for one constituent to wish to push a tax burden onto another even if the products made by both constituents are not directly competitive. The competition in spreading tax burdens may be very different from the competition in the marketplace. We do not find the evidence of legislative purpose offered by the European Communities to be particularly probative in this instance.

7.123 In our view, an important question is who receives the benefit of the dissimilar taxation. This is implicit in the reference of the Appellate Body and previous panels to the magnitude of the tax differentials. For example, the magnitude of the differentials would not be particularly relevant if the products realizing the resulting benefits were imports. Furthermore, the Appellate Body's review of the results of the application of dissimilar taxation in the marketplace in *Canada – Periodicals* shows that the Appellate Body was reviewing *who* had benefitted from the tax rate differentials. This is only logical given the language of Article III itself.

7.124 We must consider in this regard that Article III is to protect competitive opportunities. If there have been significant governmental restrictions in the market-place (which can include completely WTO consistent measures such as tariffs) it may be that there are relatively few, if any, imports and the distribution of the current benefits of the dissimilar taxation may be reflective of this fact. In such a situation, it would be necessary to consider if the large differentials could be having the effect of inhibiting potential imports.

2. Transitional System

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

- the magnitude of the tax differentials;
- the absence of legitimate policy purposes for applying a lower rate to pisco;
- the fact that the beneficiary of the differentials (pisco) is by Chilean law a domestic product;
- the fact that the vast majority of Chilean production of distilled spirits is pisco;
- the fact that the majority of whisky (the highest taxed product) is imported; and,
- the alleged admission by the Chilean government that the reason for enacting the New Chilean System is that the prior and existing systems were discriminatory.

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

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

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

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

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

3. New Chilean System

(a) Arguments

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

- (i) the European Communities argues that the magnitude of the tax differentials is large with a range from 27% for most pisco to 47% for most imports.
- (ii) the European Communities notes that these large differentials in the rates do not serve any legitimate policy purpose. It cannot be for health reasons, because there is no correlation between alcohol content and health factors related to distilled beverages. It cannot be for income redistribution, because the taxes are not just ad valorem and there is no necessary correlation between alcohol strength and value.
- (iii) the European Communities claims that the large majority of Chile's distilled beverage production (between 70 and 80 percent, according to the European Communities) will enjoy the lowest rate of taxation, while over 95% of imports will be taxed at the highest rate.
- (iv) according to the European Communities, the New Chilean System was the product of negotiations between the pisco industry and the Chilean government and reflects the desire of the pisco producers for protection from imports. The European Communities also points to statements made by various sectors of Chilean industry

and Chilean legislators to the effect that the New Chilean System was crafted to provide protection for Chilean producers.

7.132 Chile responds that their system is based on completely objective factors and therefore cannot be considered to be applied in a manner so as to afford protection. According to Chile, any producer whether foreign or domestic can produce spirits at lower levels and benefit from the tax structure. Chile noted that there are a great deal of spirits produced in the European Communities at 35° of alcohol or less that could easily be exported to Chile and enjoy a lower level of taxation. Chile also noted that there is more absolute production of domestic spirits in Chile at the higher levels of taxation than there are imports.

7.133 Chile also states that the structure was arrived at as part of a series of compromises between various government ministries. Specifically, Chile notes that there were compromises between the desire of the Finance Ministry to maintain pre-existing levels of taxation and other elements of the government that wanted higher taxes on higher alcohol content beverages. Chile notes that such compromises are normal in a democracy and do not constitute WTO-illegal discrimination.⁴²⁶

7.134 Chile argues that the Appellate Body has made it clear that statements made by legislators are irrelevant to the analysis because the subjective intent of individual legislators is impossible to discern. Chile notes that individuals may make arguments in support of their domestic industry in order to obtain better treatment and such comments may not be accurate reflections of the actual policy concerns of the government. Chile also notes that it is not surprising that the domestic industry argues for lower taxes for itself. Such lobbying of the government is perfectly normal and is found in the EC and elsewhere, too. It is also completely irrelevant, according to Chile.

7.135 Chile also argues that there is nothing in the GATT which requires a particular type of taxation or constrains the sovereign right of Member governments to structure their tax systems in a particular way. All that is required is that the tax system be based on objective factors and applied in a manner that allows any product, be it imported or domestic, to take advantage of the structure.

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

7.137 Chile argues that if protection was what it wanted, it could raise the tariffs on spirits. Chile's binding is at 25% while the applied rate is 11%. This is evidence that the purpose of the tax structure was not protective. The European Communities responded that since the 1970's Chile has applied a single flat rate to imports of all products. According to the European Communities, this is considered as one of the basic principles of Chile's trade policy and, if the Chilean authorities were to make now

⁴²⁶ We note that when we use the term "discrimination" in this discussion, we recognize that there are different nuances to the term depending on whether one is referring to the first or second sentence of Article III:2. Any difference in tax level for like products would be discrimination under the first sentence, while for directly competitive or substitutable products there is only discrimination when greater than *de minimis* dissimilar taxation is applied so as to afford protection to domestic production. Thus, we use the term "discrimination" here in a broad sense to encompass the latter meaning, recognizing that it would necessarily include the former, too.

an exception to that principle, it would be difficult for them to resist similar requests from other industries.

(b) Discussion

7.138 In light of all the evidence and arguments offered by the parties, we now proceed to examine whether the New Chilean System applies dissimilar taxes in a manner so as to afford protection to domestic production.⁴²⁷

7.139 First, we address a question of interpretation important to our examination of the New Chilean System. Chile cites some of the drafting history of the provision which eventually became Article III:2 of the GATT. Chile notes that the Sub-Committee responsible for the Article reported that:

The Sub-Committee was in agreement that under the provisions of Article 18 [Article III of the GATT], regulations and taxes would be permitted which, while perhaps having the effect of assisting the production of a particular domestic product (say, butter) are directed as much against the domestic production of another product (say, oleomargarine) of which there was substantial domestic production as they are against imports (say, imported oleomargarine).⁴²⁸

7.140 Chile draws from this the conclusion that it is permissible to have taxation systems that may have differential impact on some products including imports and domestic products as long as the distinctions are "objective and neutral".⁴²⁹ We agree that there may be differences between taxation of directly competitive products, but we see no basis for extending the statement of the sub-committee to mean that something described as "objective and neutral" can be used to justify dissimilar taxation. We recall the precepts of Articles 31 and 32 of the Vienna Convention, that our decisions should be guided by the treaty language itself and that resort to the negotiating history is useful either to confirm an understanding of the language of the treaty or to clarify the meaning in the case of ambiguity. In this case, the treaty language appears to be clear. Dissimilar taxation, as we have noted before, is not in and of itself, inconsistent with the requirements of Article III:2, second sentence. It is only if such system of dissimilar taxation is applied in a way so as to afford protection to domestic production that there is a violation of the GATT. In our view, this language of the Sub-Committee merely confirms that. There is no violation *per se* due to dissimilar taxation. It depends, in that example, on who benefits from such a taxation system and, as a corollary, who has a disadvantage. Is it the imports or some portion of the domestic industry? We see no basis for reading into this Sub-Committee report an interpretation that a system of dissimilar taxation is permissible if the criteria used to distinguish products are "objective and neutral." It says no such thing and such an interpretation would be inconsistent with the treaty language that any system which imposes dissimilar taxation in a manner so as to afford protection to domestic production is inconsistent with a Member's obligations under the GATT 1994 regardless of the alleged objectivity of the criteria chosen.

7.141 Chile says it agrees that Article III:2 applies beyond mere *de jure* discrimination to also cover *de facto* discrimination. However, when examined further, it seems that Chile actually is willing to extend Article III:2 beyond *de jure* discrimination in only the most minimal manner. According to Chile, the findings in *Japan – Taxes on Alcoholic Beverages I and II* and *Korea – Taxes on Alcoholic Beverages* are that tax systems based on "subjective" criteria such as product type names are

⁴²⁷ Chile has repeatedly urged us to take into consideration the tax systems of other Members when evaluating the New Chilean System. It is a well settled point of GATT/WTO jurisprudence that such other systems are irrelevant to an evaluation of the Member's measure which is the subject of the specific dispute.

⁴²⁸ Reports of the Committees and Principal Sub-Committees, ICITO 1/8, 64 (Geneva, Sept. 1948).

⁴²⁹ See First Submission of Chile, paras. 34-35.

impermissible. Chile then takes a further analytical step by asserting, therefore, that systems based on "objective" criteria are permissible.⁴³⁰ This step is a non-sequitur. It is the case that Japan and Korea made distinctions based on types of beverages. However, the findings with respect to the second and third analytical steps under Article III:2, second sentence, were not dependent on that fact alone. As the panel stated in *Korea – Taxes on Alcoholic Beverages*:

The structure of the Liquor Tax Law itself is discriminatory. It is based on a very broad generic definition which is defined as soju and then there are specific exceptions corresponding very closely to one or more characteristics of imported beverages that are used to identify products which receive higher tax rates. There is virtually no imported soju *so the beneficiaries of this structure are almost exclusively domestic producers.*⁴³¹

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

7.143 Chile also contends that there is not even *de facto* discrimination here because the imported product could easily be diluted to take advantage of the lower available tax rates. We do not find this persuasive. Exporters should not be required to alter important characteristics of their products and, indeed, change their generic name in order to compete equally with the domestic product.⁴³² To state it that way clearly demonstrates the flaw in the Chilean argument. It is evident that there will not be equal competitive conditions unless the foreign producers make certain important changes in their products, changes that Chile has not attempted to justify by any exception or rule of the WTO Agreements.⁴³³ The only reason Chile offers for the foreign producers to change their products is to take advantage of preferential tax rates. A measure which imposes such requirements obviously does not provide the equal competitive conditions required by Article III.

7.144 Chile argues that this is a matter of intellectual property protection irrelevant to this case. According to Chile, the EC's arguments that it should not have to change its products names in order to sell in Chile is akin to arguing that the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) is being extended to put an affirmative obligation on Chile to support the use of names such as whisky, vodka, gin and rum. We do not share Chile's view that there is such a necessary legal connection here between the concept of protected names, such as trademarks, and generic product names. The two types of names simply are not the same. The European Communities is not here asserting a trademark in the word "whisky." There is, in fact, Chilean whisky, as there is whisky produced in many countries. The issue here is whether a producer can be forced to give up its generic name and be compelled to sell its product as something different in order to enjoy equal tax treatment.

⁴³⁰ See Report, para. 4.399, Chile Second Submission, para. 28 and Chile's Statement at the Second Meeting, paras. 26-31.

⁴³¹ Panel Report on *Korea – Taxes on Alcoholic Beverages*, *supra.*, para. 10.102 (emphasis added).

⁴³² Chile argues that there is an inconsistency between arguing that products are directly competitive and substitutable and arguing that they should not be forced to change distinctive physical characteristics and names. We do not agree. Products which are directly competitive or substitutable have differences between them or they would be "like." Indeed, even like products do not need to be identical. It is perfectly logical for marketers to emphasize one product's distinctive qualities *in order to compete* effectively with other directly competitive products. We are not dealing with commodities here.

⁴³³ For instance, as justified by legitimate technical requirements or for health and safety reasons excepted under Article XX.

7.145 Furthermore, Chile is correct that it is under no obligation to assist the European Communities or any other Member in marketing its products under particular names. However, Chile is under an obligation not to apply a discriminatory tax regime to directly competitive or substitutable imports simply *because* they carry particular names. Indeed, Chile's earlier arguments concerning the decisions in *Japan – Taxes on Alcoholic Beverages I and II* and *Korea – Taxes on Alcoholic Beverages* makes Chile's position on this issue untenable. According to Chile, in those cases there was protective application of tax systems based on definitions of a favoured *type* of spirit that was overwhelmingly produced domestically. Surely it must follow that there is impermissible discrimination if a type of spirit which is mainly imported is, by definition of generic name *or type*, taxed at a higher rate.⁴³⁴ The difference is very small between a law offering favorable treatment as long as a product is called "X" and a regulation discriminating against a product if it is called "Y".⁴³⁵

7.146 Related to the question of "objective" criteria is the argument concerning the policy objectives of the taxation system. Chile states that the European Communities has no right to question its policy objectives in structuring the New Chilean System as long as its system is based on objective criteria. The European Communities replies that it is evidence of the protective application of a measure if the measure is inconsistent with the stated policy objectives. To a certain extent, both parties are correct in their arguments.

7.147 We agree with Chile that it is not for the Panel to question their policy objectives. Chile lists these objectives as: (1) maintaining revenue collection; (2) eliminating type distinctions as were found in Japan and Korea; (3) discouraging alcohol consumption; and, (4) minimizing the potentially regressive aspects of the reform of the tax system. We offer no comment on whether these are appropriate goals and objectives of tax policy. It is not for us to evaluate the measure in these terms, either to condemn it or condone it.

7.148 In our view, the failure of a measure to conform to its stated objectives may be indicative of certain aspects of its design structure and architecture. That is, while we will not examine the stated objective itself to determine its legitimacy, it is a relevant inquiry to examine the *relationship* between the stated objective and the measure in question. If a rational relationship between the stated objective and the measure is lacking, this may provide evidence of protective application, which we will take into consideration along with other factors.

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

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

7.151 With respect to discouraging alcohol consumption, the gradations based on degree of alcohol content arguably may achieve such a result, although the evidence seems to be more persuasive to the

⁴³⁴ We note that the Chilean regulation regarding alcohol content (Decree 78/1986 implementing Law No. 18,455) is not at issue in this dispute. We make no findings with respect to the consistency of this measure with Chile's WTO obligations. Rather, what we are reviewing, in part, are the results of the interaction of that Decree with the Chilean spirits taxes which are the measures at issue. Decree 78/1986 constitutes one of the relevant facts of this case.

⁴³⁵ We note that in making its projections of the fiscal impact of the New Chilean System, the Chilean Finance Ministry assumed that whisky, vodka, gin, rum and tequila would continue to be sold using their generic names.

contrary.⁴³⁶ Moreover, if there were a direct correlation such as Chile proposes then the tax differential between products with 35° of alcohol and 39° degrees of alcohol should be the same as the differential between products with, for instance, 40° and 44° of alcohol unless there is an adequate rational explanation for the difference. However, the tax rate almost doubles between 35° and 39° but is the same between 40° and 44° and such an explanation is lacking.

7.152 Even then, the Chilean response is somewhat beside the point, for this is a system based not just on alcohol content, but on *ad valorem* rates qualified by the additional criterion of alcohol content, and there appears to be no correlation between value and alcohol consumption. Or, if there is a correlation, it is more likely to be an inverse relationship. If money a consumer might set aside to purchase distilled alcoholic beverages is spent on high value products, it follows that it will result in lower absolute levels of alcohol consumption than if spent on low value products.

7.153 With respect to minimizing the regressive aspects of the tax reform, this is only true if the factual situation were to remain static. As it currently stands in the Chilean market, the lower priced spirits generally are also the lower alcohol content products, thereby reinforcing the progressive nature of the tax system if the market shares do not change prior to implementation. However, this is a coincidence of factors, not anything inherent in alcoholic beverages. For instance, in many markets there are quite low priced whiskies sold at the same alcohol content as high priced whisky. Expensive cognac sold in Chile will have a lower alcohol content than a relatively inexpensive vodka or rum, etc. As Article III is meant to protect competitive opportunities, not market shares, Chile cannot base its justification of the system on currently existing facts, (e.g., distribution of market shares across the tax rates) which may exist partially, or even primarily, due to the tax system itself.

7.154 Chile argued that the New Chilean System was a result of a series of compromises between these competing objectives so it is not totally linked to any one objective. We recognize that legislation is generally the result of compromises. However, the mere fact that compromises are necessary cannot justify the resulting legislation if it is otherwise inconsistent with WTO obligations. Furthermore, it is difficult for Chile to, on the one hand, justify its tax system based on the stated objectives, but then, on the other hand, argue that the objectives are not reached due to legislative compromises. As we noted above, if the stated objectives and the measure are inconsistent, it may provide evidence confirming the discriminatory design, structure and architecture of a measure. We find that to be the case here.

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

⁴³⁶ See EC Answers to Question C. 4 and EC Exhibit 62.

characteristic, namely their water/alcohol ratio. This is a clear case of a *de jure* discriminatory system being replaced by an at least equally *de facto* discriminatory system.⁴³⁷

7.156 As a last matter relating to the objective of the New Chilean System, Chile argues that it cannot have intended the system to be protective, for if protection was the goal Chile could have raised tariffs which are currently at 11%, but bound at 25%. Once again, we note that a lack of protective actions with respect to tariff rates is irrelevant to an examination to the completely different issue of whether a system of taxation is applied in a manner so as to afford protection to domestic production. Therefore, the fact that Chile could take protective actions that would be permissible under Article II, but chooses not to, is simply irrelevant to a finding that the New Chilean System is inconsistent with Chile's obligations under Article III.

7.157 Chile has also argued that the New Chilean System cannot be found to be applied in a manner so as to afford protection to domestic production because there actually are more domestic products at the highest level of taxation than imports. Most of this domestic production consists of high alcohol content versions of pisco.

7.158 It is important at this juncture to recall that Article III is meant to protect competitive opportunities. There is no question that the structure of the New Chilean System will distort competition between directly competitive domestic products and products which are now imported and ones that might reasonably be considered potential imports. First of all, it does not save a measure from running afoul of Article III:2, second sentence, merely because there are domestic products taxed at the same level as the imported products, as we noted in the previous section.⁴³⁸ Second, as Chile itself has noted, there is considerable world-wide supply capacity of potential imports, the majority of which would be taxed at the highest level. The potential imports have the right to equal competitive opportunities to the Chilean market which they cannot receive under the New Chilean System. Were all distilled alcoholic beverages taxed at the same level, or at a level reflecting no more than *de minimis* differences, then it is entirely possible that the percentages of domestic versus imports at 40° alcohol content or above would change dramatically. That is, lower value, high alcohol content imports could become more viable in the marketplace, particularly as consumers become more familiar with the products. In effect, Chile offers the result of its discrimination over a long period of time as a justification for perpetuating it. On balance, we find the most persuasive evidence to be that roughly 75% of domestic production will enjoy the lowest tax rate and that over 95% of current (and potential) imports will be taxed at the highest rate unless the imported products change their alcohol content and abandon their generic, familiar product names.

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

⁴³⁷ We note that, for most types of spirits, the New Chilean System will actually increase the discrimination against them compared to pisco.

⁴³⁸ See Appellate Body Report on *Canada – Periodicals*, *supra.*, p. 29. See also Panel Report on *Korea – Taxes on Alcoholic Beverages*, *supra.*, para. 10.100, fn. 412; and Panel Report on *United States – Section 337*, *supra.*, para. 5.14.

VIII. CONCLUSIONS

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

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