WHEN ECONOMICS OVERWEIGHS LAW IN GATT: CASE STUDY OF JAPAN – ALCOHOLIC BEVERAGES AND KOREA – ALCOHOLIC BEVERAGES

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DOI: 10.46609/IJSSER.2022.v07i06.010 URL: https://doi.org/10.46609/IJSSER.2022.v07i06.010

Received: 12 June 2022 / Accepted: 25 June 2022 / Published: 30 June 2022

ABSTRACT

Why do consumers purchase and select certain goods over others? What sort of products would be considered “like” or directly competitive or substitutable (DCS)? The General Agreement on Tariffs and Trade (GATT) has always been the center of World Trade Organization (WTO) trade disputes, and this paper analyzes the crucial Article III of GATT, the National Treatment (NT) obligation. The modern history of trade has offered many cases that revolve around discrimination against foreign countries and protection of domestic markets through trade. This paper uses two cases regarding alcoholic beverages as examples and analyzes the essence of ad valorem taxes, as well as legal alternatives to them. This paper views the modern effects that cause consumers to reject the classic demand theory, and seeks the true definition of “likeness.” The claim that the GATT and WTO dispute settlement process is overly legal and insufficiently based in economics is central to understanding the notions that we put forth.

1. Introduction

Article III of The General Agreement on Tariffs and Trade of 19471 (and of 1994), commonly known as the National Treatment on Taxation and Regulation, strives to prohibit usage of internal taxes to discriminate against foreign products while protecting domestic goods. Key, and widely-disputed, terms in Article III include “so as to afford protection,” and “like products.” GATT does not provide a clear definition for these two terms, and the WTO considers these terms to have different interpretations in different situations.

Thus, three main areas of dispute have centered around the term “like products”: Japan – Alcoholic Beverages\(^2\), Korea – Alcoholic Beverages\(^3\), and Chile – Alcoholic Beverages. Famously, in the Appellate Body report of Japan, the WTO uses the term “like products” to bring to mind the image of an accordion, stating:

the accordion of “likeness” stretches and squeezes in different places as different provisions of the WTO Agreement are applied.\(^4\)

It is seemingly inadequate to only view the term “like” as meaning “competitive” or “substitutable” from an economic perspective. Thus, like product tests have been developed to address this issue, and through the pressure of time, two main approaches were formed to deal with the three disputed concepts listed above. These consisted of a flexible approach that matched the purpose of Article III, and a literal approach that sought to fully execute Article III.

Economists have commented on these two approaches since they were first brought up by the WTO. Almost all call for a revised aims-and-effects test, due to its substantive viewpoint and overemphasis of the test leading to confusion. The interpretation of “like products” and “so as to afford protection” has also been analyzed to great extents, as will be presented in section II. These selections of written interpretation concluded that the definition used by the WTO focused mainly on the economic substitutability, physical characteristics, and functionality. As previously mentioned, countries that wish to cite the NT obligation in disputes have two approaches of doing so. One is to deem domestic and foreign products as like, and then prove the latter is taxed excessively \textit{vis a vis} the former. The second is to consider the products as “directly competitive or substitutable,” and then demonstrate their being taxed differently, providing reasoning that the tax is set “so as to afford protection” to the former.

On the basis of prior literature, the purpose of this paper is to:

(1) Differentiate between “like” and “directly competitive or substitutable” products
(2) Explain the reasons why consumers choose similar products over one another
(3) Determine elements that make products “substitutable”

\(^2\)Hereinafter Japan

\(^3\) Hereinafter Korea

\(^4\)See N.1.3.1.2 Japan — Alcoholic Beverages II, p. 21, DSR 1996:I, p. 97 at 114
(4) On a side note, analyze the term “protection” in controversial usage, as in “so as to afford protection.”

This research differentiates itself from prior papers by focusing on the role of the consumer in a market. A key to explaining the above-referenced list is to think from a consumer’s angle and investigate rationale (besides price and income factors) that impacts product choice and sales. Comparing and contrasting the cases of Japan and Korea, this paper strives to find the fine line between “like” and “in-competition.” This is one of the first works of research in which real-world consumer preferences will be examined by “likeness.” This research will provide a modern approach and update a topic that was widely discussed decades ago, incorporating new consumer psychology in a market different from that of the past. A breakthrough presented in this paper is the finding of the flaw in legal approaches to economic disputes regarding Article III:2, as this clause creates great amounts of ambiguity regarding interpretation of the meaning of “likeness.” This paper claims that an economic approach regarding substitutability would be much simpler, both financially and legally.

Section II is a review of previous literature regarding this topic. The reader should have a clear sense of the evolution of the interpretation and implementation of case law after this section. Section III elaborates on the specifics of both WTO cases, Japan and Korea, including the opinions of complainant and respondent countries, as well as statistics regarding alcohol in East Asia.

Section IV includes official WTO recommendations of these case studies in the Panel and AB report, and an interpretation of the meanings, processes, and faults with these conclusions. The WTO in both cases considered an all-around approach to determining the likeness of products, and though both this paper and their efforts to find the respondent countries at fault, this paper notices how Japan and Korea could have done otherwise.

Section V connects all previously mentioned details in a model of modern free trade argument, specifically that of imperfect competition. Considering the likeness of products, this research concludes that consumer behavior and psychology, such as the snob effect and bandwagon effect, as well as cultural meaning and end usage of products, matter as much as market share and elasticity.

Substitution and competitiveness should not only be viewed from the perspective of cross-price elasticity, but also within the context of the list above. On a wider scale, however, this paper also claims that the WTO made the correct decision in both Japan and Korea. Both cases involved countries aiming to protect their domestic market with taxes upon imported alcoholic beverages,
and this paper claims that they had much better alternatives. The paper provides alternatives to the illegal approaches that Korea and Japan took, such as the use of specific taxes at the point of entry, the use of excise taxes at the point of retail sales and the establishment of a specific port of entry for alcohol and the creation of GATT legal labeling requirements. All these measures could provide local producers of distilled alcohol with needed protection without violating the GATT/WTO rules.

2. Literature Review of GATT Article III and “Like Products”

Multiple economists have previously formulated opinions, arguments, and case studies concerning the term “like products” and the core pillar of the GATT, Article III. This paper combines modern ideas about the applicability and interpretation of the National Treatment (NT) obligation, which was constructed using empirical and factual analysis from prior papers.

The closest significant research regarding Article III was conducted by a group of Japanese economists. Naoshi Doi and Hiroshi Ohashi published Empirical Analysis of the National Treatment Obligation Under the WTO in 2017. They focused on a case study called Japan – Alcoholic Beverages. Doi and Ohashi performed a Small but Significant Non-transitory Increase in Prices (SSNIP) test, which found that Shochu and imported alcohol were not comprised in the same relevant market. Then, they used a random-coefficient discrete-choice model, one that was rarely used in any other analytical paper related to this subject, and found that: 1. Consumers with higher income prefer beverages with lower alcohol content, and 2. The average consumer is indifferent to whether the alcoholic beverage in question is distilled or brewed. Specifically, results found that the NT obligation had limitations regarding determinative tax levels, and that Japanese issuance of new tax rates raised consumer surplus by over 310 million USD. However, cross-price elasticity estimations revealed that the relationship between Shochu and imported alcoholic beverages was far more complicated than merely one of DCS products. Their mathematical approach is unique and counters the WTO claim that local Japanese Shochu is directly competitive with imported alcohol.

A decade previously, economists Petros Mavroidis and Henrik Horn wrote critical papers that contributed to the analysis of GATT Article III, including Legal and Economic Principles of

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6 Small but significant and non-transitory increase in price
World Trade Law: National Treatment and Still Hazy after All These Years. The prior explains the rationale, along with implementation and interpretation, of the National Treatment obligation. The latter concludes that GATT formed an “obligationally incomplete contract,” and that multiple terms in Article III are open to a variety of interpretations due to limited clarification. This article prompted a change in the explanation of Article III. Both articles provide empirical analyses of “like” and “directly competitive” product tests used in WTO scenarios and inform the understanding of the NT obligation. These two economists present research with high credibility and provide insight into the evolution of the NT obligation throughout the decades.

In the late 1990s and early 2000s, a renewed version of GATT, called GATT 1994, was published, and multiple WTO disputes revolving around tax and the National Treatment obligation, such as Japan – Alcoholic Beverages and Korea – Alcoholic Beverages, occurred. This led to an increase in research regarding this topic.

In this period, world trade economist Robert E. Hudec served as an indispensable source of knowledge when analyzing GATT and the National Treatment Law. Hudec’s paper “Like Product”: The Differences in Meaning in GATT Articles I and III concludes that the GATT characteristic-based definition of “like products” is inadequate in most scenarios, suggesting a more economics-based approach to interpreting this term. From an economic standpoint, like product substitution results in a decrease in sales when price rises due to competition and alternatives. However, as defined by the WTO and analyzed by Hudec, the criterion of likeness not only involves economic competition, but also end uses, characteristics, consumer preferences and substitutability. It is important to note here that Japan – Alcoholic Beverages had reached settlement two years before, and Korea – Alcoholic Beverages was settled around the same time this paper was published. Hudec’s interpretation is widely cited in research of this concept and is thus a key reference of definition in my paper.

On the other hand, Hudec’s GATT/WTO Constraints on National Regulation: Requiem for an "Aim and Effects" Test provides a clear description of the “Aim and Effects” test and the

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evolution of this like product concept using case examples, including *Japan – Alcoholic Beverages*. This research is heavily referenced in other articles to understand the details behind the WTO settlement of disputes regarding Article III:2.

Prior to Hudec, Mavroidis and Horn, the term “like products” was also rigorously analyzed in Edward S. Tsai’s *Like Is a Four-Letter Word - GATT Article III’s Like Product Conundrum*.11 Tsai concludes, using WTO cases involving Article III:2 and III:4, that the term “like products” should be deemphasized and the aim-and-effects like product test modified to prevent continued confusion, a proposal ahead of and similar to Hudec’s. A crucial differentiation in this research is that the purpose of Article III:2 was to prevent government measures with protectionist intent, instead of preventing measures with discrimination.

Besides looking at specific terms and tests in GATT, many researchers also commented on other aspects of the NT obligation. Case Western Reserve University professors Peter M. Gerhart and Michael S. Baron analyzed the decision-making process of the WTO regarding the NT obligation and dispute settlement in *Understanding National Treatment*.12 They presented an innovative process-based review process, which the two professors use to outweigh the “substantive” view the WTO uses in dispute settlement processes. The two professors found that the notion of an aims-and-effects test, in the “substantive” view, not only brings about friction regarding national sovereignty but is also missing support from legal texts. This process-based approach can determine whether “the interests of foreigner products were undercut and stymied.” This research is crucial in my knowledge of WTO dispute settlement regarding cases breaking the reasoning of Article III.

Guided by the previously mentioned Mavroidis, Damien Neven published a paper about the aftermath of non-tariff measures13 in 2000. The research focuses on the term “protection” of Article III:2 and helps deconstruct Article III when viewed hand in hand with Hudec’s *Like Product* research. Neven also offers a method to evaluate protection in trade disputes by first


Neven’s finished paper was not found on the internet, and this citation was a version deemed “draft”.

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confirming that price is a measure of protection. Due to limited resources related to finding this report, credibility is low, and certain edits to the paper must have been made, as the cited report was only a “draft” version. This article can be viewed together with Celine Carrere’s analysis on detecting the impacts of non-tariff barriers,14 which, combined, help provide a personal recognition of the cases to be analyzed in this paper.

Moving a decade back to pre-Japan – Alcoholic Beverages, John H. Jackson of Michigan Law School conducted research titled National Treatment Obligations and Non-Tariff Barriers.15 As seen today, many facts and trade norms in the research are quite outdated, but the paper serves as a time capsule for interpreting the meaning of GATT and Article III. Without modern WTO case examples, this research was based upon textual evidence and the author’s logical analysis of economic discrimination and the application of Article III.

Last but not least, multiple official WTO websites and articles help clarify the intent of GATT to the public and countries in specific cases. Panel Reports and Appellate Body Reports throughout the ages continue to define terms included in Article III. The International Trade Law Reports helped analyze different WTO treatments of cases regarding Article III. Similar to what was stated aptly in the AB Report of Japan – Alcoholic Beverages,16 the definition of terms is like an accordion that “stretches and squeezes in different places as different provisions of the WTO Agreement are applied.” Japan - Alcoholic Beverages, according to the research reviewed, was a common case study due to it being the first NT obligation case of its kind, and the blurred lines of “like products” and “directly substitutable products” in the WTO dispute settlement process.

Most of the above-cited literature, when read in chronological order, helps paint a picture of the development of ideas regarding Article III of GA TT. From the Japanese empirical research, I learned that the National Treatment obligation’s purpose, when approached from a mathematical perspective, hinders a welfare-maximizing policy. Hudec’s analysis of the aims-and-effects test, together with Gerhart and Baron’s process-based like product test, informed me of the reasons why the “aims-and-effects” approach isn’t adequate, and the latter provided a justifiable alternative. My understanding of the developments of WTO application of the NT obligation


became clearer, from various tests to definitions and implementations after trade disputes.

In addition to the above-referenced literature regarding the GATT, literature regarding hedonic demand and cultural differences was also consulted; it included Harvey Leibenstein’s 1950 publication, *Bandwagon, Snob, and Veblen Effects in the Theory of Consumers' Demand.* Though written over half a century ago, this was one of the earliest attempts to incorporate behavioral economics and psychology of consumers into modern demand theory. These external consumption effects include the Bandwagon effect, Snob effect, and Veblen effect. Through analysis of consumer behavior and reaction to changes in price, Leibenstein was able to conclude the following notions: the bandwagon effect increases elasticity; the snob effect decreases elasticity of the demand curve; and the Veblen effect decreases the elasticity, while some of the demand curve may even be positively inclined. This knowledge dramatically impacts real-world applications of the consumer demand theory.

Another popular piece of research on this topic is *Hedonic Shopping Motivations* by Mark J. Arnold and Kristy E. Reynolds. By creating six categories of hedonic shopping motivations, respectively “Adventure Shopping,” “Gratification Shopping,” “Social Shopping,” “Role Shopping,” “Value Shopping,” and “Idea Shopping,” the research captures the reasoning behind this activity. By proving that modern consumers shop for multiple reasons besides needing the product itself, it can be inferred that the classical demand theory may slowly lose application in the modern market, especially in specific product markets and developed countries.

After analyzing the above-noted articles and referring to research regarding alcohol consumption statistics in East Asia, I found that not many papers analyzed like products while considering their end uses, cultural differences, and consumer demand motivations. In that sense, GATT case law and research align with Western cultural norms (specifically product and consumer-related ones), alluding to characteristics of other cultures unable to conform under GATT. While physical characteristics and relevant markets do matter, behavioral elements of consumers and ultimate uses of products also influence their being “like” or “substitutable,” as well as the demand for them. If these factors differ dramatically in products that have previously been

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deemed as “like,” would consumers consider them “substitutable” products? Thus, the following questions arise:

1. What causes consumers to purchase one product over another?
2. What defines the “protection” of domestic goods?
3. What determines whether products are “substitutable” or not?

This research analyzes products from the view of a teenage consumer and uses widely-accepted models to help explain the concept of “like products.” It approaches these debated articles from not only economic and legal standpoints but also from a behavioral perspective. By analyzing the GATT and the WTO’s inability to factor a variety of cultures into the dispute settlement process, this research uncovers flaws in the GATT, especially when dealing with non-Western and non-developed countries. It also draws conclusions based on earlier research and interprets the impacts of the NT obligation by using Japan – Alcoholic Beverages and Korea – Alcoholic Beverages as case examples. These cases will be introduced in the next section.

3. Specifics of Japan and Korea

The cases of Japan – Alcoholic Beverage sand Korea - Alcoholic Beverages occurred in the late 1990s, and revolved around alcoholic beverages, unequal taxes, and Article III.

Prior to Japan, the European Community had also requested consultations with Japan on the Alcoholic Beverage Tax, in 1987. \(^{20}\)The panel, in that case, concluded that all distilled liquors were in a “directly competitive or substitutable” relationship with one another in Japan. Japan was found to have violated Article III:2 and had to lower whiskey/brandy taxes substantially while raising them for Shochu.

In June 1995, the European Community once again requested consultations with Japan regarding the new Imported Alcohol Tax Law. Canada and the USA joined these consultations in July. All three complainants argued that Japan, by levying higher taxes on imported alcohol (spirits, whisky, liqueurs etc.) had breached the requirements of Article III:2. Specifically, they argued that spirits formed a “like product” relationship to Shochu and that other alcoholic beverages were DCS with Shochu, effectively stating that a higher tax on beverages besides Shochu meant that a violation of the NT obligation had occurred.

The law at that time categorized beverages into seven main types, four of which are in question for purposes of the following dispute. These include *Shochu*, spirits, liqueurs and whiskey/brandy. Assuming that a bottle of each of these beverages would be 750 ml in volume, with a 40% alcohol content, according to the Tax Law, the respective tax amounts would be as follows: whiskey/brandy: ¥737, spirits (rum, vodka, etc.): ¥298, liqueur: ¥247, with local *Shochu Otsu* and *Ko* levied at ¥185 and ¥121, respectively. However, due to the alcohol content of *Shochu* rarely exceeding 30%, the actual tax rates may differ even more. Attached in the appendix is a WTO graph regarding pre-1995 tax rates in Japan.

It should be noted here, using statistics provided by the Japanese National Tax Agency and Makiko Omura in his paper regarding the impacts of Liquor Taxes, that although the consumption rate was relatively low, whiskey and spirits were nonetheless being consumed at around 10,000 kl per year prior to 1995. This proves that Japan had a sufficient amount of imported alcohol consumption. However, many of these consumers purchased imported beverages due to the “snob effect,” causing whiskey and spirits to be highly inelastic drinks in Japan. An alcohol consumption chart, created by Omura in his paper, will be cited and included in the appendix.

Both the U.S. and Japan suggested using an “aims-and-effect” test to verify whether the intent of the taxes was to provide protection to domestic products, i.e. *Shochu*. Specifically, the Japanese defense provided a highly restrictive definition of “like products,” claiming that the beverages listed in the previous paragraph did not hold such a relationship due to lack of identical factors. Even if the beverages in the case above were considered “like products,” Japan claimed that a violation of Article III could occur only if the intent of the taxes was to provide protection for domestic products. Japan’s main argument against validity of the phrase “so as to afford protection” was premised on its belief that three conditions had to be cumulatively established: existence of dissimilar price/tax ratios, the exclusive domestic production of the domestic product, and existence of a DCS relationship.

On the other hand, the arguments and tests of the complainants varied. The Panel eventually used the test recommended by the European Community as a means to legally analyze the first sentence of Article III:2, and the test recommended by Canadian authorities for the second sentence of III:2. The former called for: 1. Determination of whether the products were “like” and 2. Establishment of whether the taxes levied were discriminatory. It is worth noting that the

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21 A comparison of these beverages will be included further in the text.

EC’s definition of “discriminatory” was premised on whether the tax rate of domestic products was less than that of imported goods, no matter how small the difference.

Canada claimed that the following four criteria must be satisfied in order for the second sentence of Article III:2 to be violated: 1. The taxes levied by the Liquor Tax Law are internal taxes; 2. Whiskey\(^2^3\) is DCS with Shochu; 3. Whiskey and Shochu are not similarly taxed; and 4. The taxes levied by the Liquor Tax Law afford protection to domestic production of Shochu. Canada defined “affording protection” with three variables: 1. Lower tax rates on domestic products; 2. Exclusive domestic production of domestic products; and 3. Whether domestic and imported products are substitutable.

These definitions and processes are worth noting when compared with the definitions used in Korea, below, which will be crucial to analyzing WTO opinions and treatment of these similar cases.

Korea began in a relatively similar manner, with Korea’s Liquor Tax Law (and Education Tax Law\(^2^4\)) resulting in complaints from the European Community and the United States. Due to previous communications, Korea had already lowered tax rates of alcoholic beverages prior to this case, but had simultaneously raised the education tax rates, thus fundamentally modifying the charges applicable to imported liquor by a minimal amount.

Korea’s liquor tax law featured eleven categories, including "soju," "whiskey," "brandy," "general distilled liquors," "liqueurs," and "other liquors." Diluted Soju and Distilled Soju have 35% and 50% tax rates, while whiskey, brandy, and general distilled liquors have 100%, 100%, and 80% tax rates, respectively. On top of that, an Education Tax Law surtax is administered as a percentage of the liquor tax, with soju taxed at 10% and most other imported alcohol at 30%. Full outlines of the Liquor Tax Law and Education Tax Law will be included in the appendix.

Statistic-wise, near 100% of all brandy, liqueurs and whiskey consumed in Korea was imported at the time of the case in question. However, almost 94% of the Korean distilled spirit market was claimed by Soju, which was rarely imported at that time. Imported alcohol was considered a “luxury” item, leading to demand among affluent consumers associated with the snob effect.

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\(^2^3\)Whiskey is the specific alcoholic beverage used in the Canadian test since the only product Canada found in violation of Article III when imported to Japan was Canadian whiskey. This was further expanded by the WTO to include other alcoholic beverages as well.

\(^2^4\)The rates listed in the Education Tax Law are meant to be a surtax, calculated as a percentage of the liquor taxes already imposed.
After modification of the Liquor Tax Law in the early 1990s, Korea’s whiskey market increased by over 30% every year. Regarding consumption statistics, demand for other imported alcohol also presented an increasing trend following the lowering of the tax.

Regarding case law, the approaches of the European Communities (EC) and United States were followed. The EC claimed that Korea breached the first sentence of Article III:2 by applying taxes on imported vodka in excess of those on domestic soju, and that it breached the second sentence of Article III:2 by applying taxes on whiskey, brandy, general distilled liquors, liqueurs and other liquors so as to afford protection to domestic soju. The United States had, in general, the same proof process, but claimed that the second sentence was violated not only because of protection, but also because of higher tax rates on imported goods.

The EC, while formulating its argument, compared many elements of this case with those encountered in Japan, stating that imported alcohol holds an even smaller share in the Korean market than in pre-1995 Japan, as mentioned previously. By stating that alcoholic beverages are directly competitive with soju, the EC claims that taxes hinder competition between different varieties of alcohol. On the other hand, the US cites Korea’s history of closing its market on imported alcohol as a key reason for proving the existence of Korea’s protection of soju. The U.S. also claims that tax rates are the main reason for imported alcohol occupying only 3.5% of the Korean market.

Korea’s defensive arguments were engaged from five main perspectives: direct arguments, price, the nature of soju in general, consumer behavior and previous changes. Korea’s approach involved claiming that soju was not in a DCS relationship with imported alcohol, a difference when compared to Japan. As will be seen in this case, consumer behavior and perception proved to be factors in making the final deductions and decisions. Korea was the first to raise a point regarding the influence of culture in the interpretation of the meaning of “like products,” but later in this paper, we will prove that culture shouldn’t necessarily be included in such a case.

Regarding alcohol consumption statistics, it can be clearly observed that Japan and Korea set high tax rates on imported alcohol in order to change the views of consumers, and to cause them to switch to domestically produced alcohol. Unbeknownst (at least objectively) to both governments, consumers of imported alcohol rarely considered price a factor in alcohol purchases. These cases present a similar detail: that both countries’ policies could have had the same effect on imported alcohol, but their methods were grossly in accurate. Both cases present with similar contexts; the Panel and AB Reports considered different elements and both sides of the arguments, but still differ in specific findings. These reports will be introduced in the
4. Panel & AB Reports of Japan and Korea

As mentioned in the previous section, the Japan and Korea cases followed similar approaches.

To recap, in Japan, the complainants each provided an alternative claim (considering DCS products) if the Panel failed to find a like product relationship between imported alcohols and Shochu. The defendant, Japan, conversely claimed that its taxation system did not violate Article III, and that Shochu did not form a like or DCS relationship with any of the above-mentioned beverages.

Japan and the United States proposed the usage of an aims-and-effects test. However, the Panel referenced Article III:2, first sentence, to defer this option, due to a lack of textual and contextual support. By simultaneously referencing the 1992 Malt Beverages case and the U.S. Auto Taxes case, the Panel further rejected the interpretation of the term “like product” as it appears in Article III:2, first sentence. Thus, the Panel developed its own test concerning this specific case, detailing: 1. Whether the products in this regard are “like”; and 2. Whether the tax imposed on foreign products is in excess of that of domestic products.

When analyzing the relationship between vodka and Shochu, the panel first referenced criterions of “like products” in previous cases, then concluded that these criteria should be decided on a case-to-case basis. The Panel then noticed an almost exact identity between the above-mentioned beverages; ergo, concluding them to be like products. Based on tax rates, the Panel then concluded that vodka was taxed in excess of Shochu. Japan refuted this by stating that the tax/price ratio was “roughly constant,” and trade was conducted neutrally, with no purpose of affording protection. This was strictly rejected by the Panel, since the tax/price ratio was not the benchmark defined by Article III:2, first sentence.

The Panel then turned to the concerns of imported DCS products. The burden of proof on the complainants in this regard required that they: 1. Prove that beverages were in a DCS relationship; and 2. Show that taxes were levied upon foreign products so as to afford protection to domestic products. The Panel declared whiskey, spirits, brandy and other beverages mentioned in previous sections as DCS with Shochu based on evidence from Canada showing that these beverages shared the same market and that there was elasticity of demand. Japan argued that demand for Shochu was not sensitive to any change in the price of whiskey; however, the Panel did not support this argument, stating that price was already a factor in consumer decisions, and other factors were not equal in this study. Therefore, the Panel moved onto the next step, which
was to analyze the term “protection.” Based on per-kiloliter and per-degree tax rates, the Panel ruled that the amounts of taxes were not similar, and the differences were not *deminim is*. Japan’s tax/price ratio argument was also not adopted, due to a separation in imported and domestic alcohol, and the fact that retail prices were recommended (not actual “discounted” prices). In consequence, Japan’s actions led to imported alcohol having a harder time being placed in the Japanese market. The Panel also noted Japan’s repudiation of the argument that *Shochu* is essentially a Japanese product. However, that was not the case, and high import duties on foreign *Shochu* made it difficult for it to penetrate the local market, which did not guarantee equal competitiveness between *Shochu* and other “white” and “brown” spirits. Japan’s modification to the Liquor Tax Law was thus an attempt to protect the domestic market for *Shochu*.

Therefore, based on all the above, the Panel ruled that Japan violated the first and second sentences of Article III:2, and recommended edits to the Liquor Tax Law in order to conform to regulations.

Japan and the United States appealed this final judgement, leading to the formation of an Appellate Body. Japan largely disagreed with the Panel Report, stating that it erred in multiple sections, including: 1. Failing to interpret Article III:2 in light of Article III:1; 2. Rejecting an aims-and-effect test; 3. Not comparing the tax treatment of domestic products as a whole and foreign product as a whole; 4. Failing to consider tax/price ratio as a tool to review the case; and 5. Placing overemphasis on tariff classification as a criterion for “like product.” The United States agreed with the final judgement, but still appealed due to errors it believed the Panel made. These included but are not limited to: 1. Failing to interpret Article III:2 in light of Article III:1; 2. Failing to find that all distilled spirits are "like products"; 3. Erring in equating “not similarly taxed” with “so as to afford protection”; 4. Erring in conclusions regarding DCS by using cross-price elasticity as the main criterion.

Using analysis of case law and the Panel report, the Appellate Body still found Japan’s actions in violation of Article III:2. However, the AB did confirm that conclusions made from previous cases should not be adopted, and that the Panel failed to analyze Article III:2 on the basis of Article III:1. These findings have no major impact on the final case, but the outcome does show that post-*Japan*, the WTO had a great amount of power over national sovereignty in trade. In this case, one of Japan’s firmest arguments was that of “likeness” being defined narrowly, with no room for other criteria.

Famously, the AB report of the *Japan* case includes this metaphor:

The concept of "likeness" is a relative one that evokes the image of an accordion. The accordion
of "likeness" stretches and squeezes in different places as different provisions of the WTO Agreement are applied. The width of the accordion in any one of those places must be determined by the particular provision in which the term "like" is encountered as well as by the context and the circumstances that prevail in any given case to which that provision may apply.

Korea, as mentioned previously, followed a similar approach. Both the European Communities and the United States argued that vodka formed a “like product” relationship with Soju. They also claimed that Soju and imported alcoholic beverages were taxed dissimilarly, infringing both the first and second sentences of Article III:2. Importantly, Korea noted the impact of culture, claiming that Soju had cultural significance that outweighed imported alcohol. This was a first, as at the time, no prior WTO dispute settlement had referenced culture.

Throughout the analysis of the Panel, end uses, advertising, physical characteristics and price were among the factors considered. Korea was the first case in which consumer perceptions about alcoholic beverages were taken into account. Advertisement, just like human cognition and emotions, influences what consumers consider to be “like” or DCS.

The Panel focused much attention on the word “directly” in the key terminology known as “directly competitive or substitutable.” In the end, the Panel used not only a quantitative approach to determining likeness, but also a qualitative one. However, the Panel disagreed with Korea’s statement that like products had to not only be physically identical, but also be perceived identically by Korean consumers. Due to every distilled alcoholic beverage being composed mainly of ethyl alcohol, the Panel deemed them as directly competitive or substitutable products.

Regarding end uses, Korea stated that the high price of imported alcohol makes it impossible to consume these products in the same manner and on the same occasions as Soju. Statistically, in “high-end” Western restaurants, 22710 ml of Soju was sold compared to 11702 ml of whiskey, per month. This refutes Korea’s claim that imported alcohol products had a major market share in Western restaurants and pubs in Korea. All in all, the Panel was unconvinced by Korea’s attempt to utilize differences between consumption occasions and uses as a fundamental point in this case. Considering distribution, the Panel found that there was sufficient evidence to prove that overlap exists in channels of distribution of domestic Soju and imported beverages.

Altogether, the Panel gained enough information to claim that Korea was at fault in this case by taxing imported alcoholic beverages more heavily than a domestic DCS product, Soju. The Panel did not have sufficient evidence, nor did it wish to use as strict a definition as the one employed in the Japan case, to prove that vodka and Soju formed a like product relationship.

Multiple parties appealed this Panel report, which resulted in the formation of an Appellate Body.
In the appeal, Korea claimed that any similar product could be deemed “competitive,” that the term “directly” was not afforded enough weight; and that the Panel focused unduly on “potential” competition. Two other main subjects of debate in this appeal were the Panel’s interpretation and execution of the “so as to afford protection” clause, and the Panel’s allocation of the burden of proof upon Korea. Both the EC and the U.S. restated their original arguments, asserting that many of Korea’s definitions were too narrow, and that their points regarding DCS differentiation did not hold. The AB eventually found that the Panel made no mistakes either in logic or case law. Korea had failed to prove that the Panel made any mistakes in judgement, resulting in a major edit to the Liquor Tax Law. As we will uncover, both the Panel and AB (in both cases) made no major mistakes, leading to the conclusion that variations of criteria for likeness never manage to conquer true offenses in a world of free and unencumbered trade.

Both cases present similar details, similar processes and similar mistakes made on the defending sides. Korea and Japan, as I will discuss in the next section, had alternative options to preserve their local markets. Setting border taxes lowered their state of economic wellness, and injured their reputation in the world of trade. From a larger perspective, these two cases also signify the highlights of a never-ending debate regarding III:2, and how it should be interpreted in legal cases.

5. Research, Analysis & Interpretations

5.1 A Comparison of Beverages

Considering that the Japan and Korea cases were centered around alcoholic beverages, a comparison of alcohol is needed, since physical characteristics are always critical in determining likeness. The table below compares most of the alcoholic beverages mentioned in this paper.

<table>
<thead>
<tr>
<th>Alcoholic Beverage Characteristic Chart</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shochu A</td>
</tr>
<tr>
<td>Raw Material</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Production</td>
</tr>
<tr>
<td>------------------</td>
</tr>
<tr>
<td>Alcohol Content</td>
</tr>
<tr>
<td>Characteristics</td>
</tr>
<tr>
<td>Chemical Composition</td>
</tr>
<tr>
<td>End Uses</td>
</tr>
<tr>
<td>Retail Price (40% 750 ml)</td>
</tr>
</tbody>
</table>

Alcoholic Beverage Comparison Chart

<table>
<thead>
<tr>
<th>Whiskey</th>
<th>Brandy</th>
<th>Vodka</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Raw Material</td>
<td>Fermented grain mash (Barley, corn, rye, wheat, etc.)</td>
<td>Fermented fruit juice (Grapes, apples, apricots, etc.)</td>
</tr>
<tr>
<td>-----------------------</td>
<td>-------------------------------------------------------</td>
<td>-------------------------------------------------------</td>
</tr>
<tr>
<td>Production</td>
<td>Distilled two or three times; Pot still/Column stills; Aged in wooden casks[^25]</td>
<td>Double distillation; Pot still/Column still; Aged in oak casks/unaged</td>
</tr>
<tr>
<td>Alcohol Content</td>
<td>At least 40%</td>
<td>35%-60%</td>
</tr>
<tr>
<td>Characteristics</td>
<td>Light golden to rich brown color; Smooth and smoky</td>
<td>Fruity, semi-sweet golden-brown color; Concentrated distilled wine</td>
</tr>
<tr>
<td>Chemical Composition</td>
<td>Vast amounts of flavoring compounds (200 to 300) (Phenolic compounds, whiskey lactones, aldehydes, esters, sulfates etc.)[^26]</td>
<td>65–100 mg/liter alcohol aldehydes and acetalts, oak lactones, phenolic aldehyde derivatives, ethyl esters</td>
</tr>
<tr>
<td>End Uses</td>
<td>Pubs, restaurants&amp;alcohol</td>
<td>Drinking at high-end</td>
</tr>
</tbody>
</table>

[^25]: A long and slim shape produces soft, pure alcohol while a short, squat shape produces strong, intense flavors

[^26]: Carbonyl compounds, alcohols, carboxylic acids and their esters, nitrogen- and sulfur-containing compounds, tannins, and other polyphenolic compounds, terpenes, and oxygen-containing, heterocyclic compounds” and esters of fatty acids
<table>
<thead>
<tr>
<th>Alcoholic Beverage Characteristic Chart (cont.)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Gin</strong></td>
</tr>
<tr>
<td>Raw Material</td>
</tr>
<tr>
<td>Juniper berries</td>
</tr>
<tr>
<td>Barley (grain)</td>
</tr>
<tr>
<td>Production</td>
</tr>
<tr>
<td>Pot distilled;</td>
</tr>
<tr>
<td>Column distilled;</td>
</tr>
<tr>
<td>Compound; Pass through spices in second</td>
</tr>
<tr>
<td>distillation</td>
</tr>
<tr>
<td>Alcohol Content</td>
</tr>
<tr>
<td>35%-55%</td>
</tr>
<tr>
<td>Characteristics</td>
</tr>
<tr>
<td>Full of flavoring agents;</td>
</tr>
<tr>
<td>Herbal and dry; Diverse yet unique</td>
</tr>
<tr>
<td>Chemical Composition</td>
</tr>
<tr>
<td>Alcohol, water, and flavoring agents such as</td>
</tr>
<tr>
<td>alpha-pinene, beta-myrcene, limonene,</td>
</tr>
<tr>
<td>gamma-terpinene, p-cymene, sabinine, and</td>
</tr>
<tr>
<td>beta-pinene</td>
</tr>
</tbody>
</table>
End Uses | Low consumption in Japan & Korea; Mainly consumed in cocktails | Consumed in cocktails or consumed straight; Low consumption in Asian countries | Served after meals; Cocktail, layered drinks; Rising consumption in Japan
---|---|---|---
Retail Price Net of Tax (40% 750mL) | 1285 Yen | 2050 Yen | 4133 Yen

_Alcoholic Beverage Comparison Chart_

When considering whether products are like, every Panel first analyzes similarities in their physical characteristics. The chart above summarizes the main characteristics and other criteria mentioned in “like product tests,” including of all alcoholic beverages involved in these two cases.

In Korea, the defendant cited “end uses” (culture-based) as a main argument to differentiate between imported beverages and domestic Shochu. As stated by the Panel, products that are perfect substitutes may be considered like; imperfect substitutes may be considered DCS, while definitions are made on a case-by-case situation. The text in _Japan – Custom Duties, Taxes and Labeling Practices on Imported Wines and Alcoholic Beverages 1987_ proposed that the four main criteria for judging likeness are physical characteristics, function, tariff applications and consumer habits. It should be noted that a small variation in consumer habits/taste does not affect products being characterized as like.

Thus, drawing a conclusion from the above-noted chart, every alcoholic beverage involved in this dilemma is a distilled spirit. Though there are differences in taste and color due to a variety of added chemicals, every beverage is formed on the basis of ethyl alcohol and water. Besides liqueurs, which are a mix of beverages, this comparison finds that all distilled alcoholic beverages hold similar physical characteristics.

In terms of end uses, it is safe to utilize Korea’s Panel, which concluded, “All the beverages described are utilized for socialization purposes in situations where the effect of drinks containing relatively high concentrations of alcohol is desired.”

In both Japan & Korea, statistics (positive cross-price elasticities) show that Shochu and Soju respectively share the alcohol market with their imported counterparts. A 20% rise in price of

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27 Hereinafter Japan 1987
domestic Soju indeed increases the demand of imported white spirits, according to a study presented by the complainants in the Korea case. The same can be said for Japan.

Thus, the Panel was correct in both cases when judging domestically produced Shochu and Soju as DCS with other distilled spirits. However, there is not enough evidence to claim that either Shochu or Soju forms a like product relationship to vodka, as the definition of “likeness” is another conundrum by itself.

We note here that this comparison chart is in accord with the criterion of “likeness” in most WTO disputes. However, in Korea, the arguments made by both sides regarding “likeness” are well off the charts of GATT and WTO interpretations. We assert that the definition of “likeness” and DCS should only depend on economic and physical characteristics. An approach similar to that made in Korea is overly legal in an economic debate, and too much effort was put into examining all the different characteristics of alcoholic beverages, as in the end, the products in question are all distilled spirits. Economic substitutability, cross-price elasticity and market statistics should have been focused upon more in both cases. Understandably, this is due to GATT being a legal text; however, an economic approach would have saved a considerable amount of cost and effort. Assuming that all spirits exist in matching markets, it would be easy to conclude that they hold a DCS, if not like, relationship to each other.

5.2 Consumer Preferences Regarding Alcohol

Before delving into alternative paths Korea and Japan could have taken, we will first examine explanations regarding the demand for imported alcohol in the two countries. The classic demand theory states that the higher the price of a product is, all else being equal, the less of it will be demanded. However, in the modern world, that is not the case.

The concept of purchasing a product to attain exclusivity, pride or some other type of cachet was first mentioned by Harvey Leibenstein in 1950. Moving into the 21st century, combined with increasing social pressure to own monetary wealth, a greater number of people purchased products to seek the admiration or acceptance of others. In Eastern Asian countries, ever since the late twentieth century, engaging in the customs and acquisition of goods related to Western culture has seemingly increased individual social status. From a behavioral perspective, these actions boost pride and make people feel superior to their peers.

Based off of a report submitted by the complainants in Korea, imported alcoholic beverages were sold mainly in high-class restaurants, karaoke clubs and bars. In comparison, Soju could also be seen on the shelves of supermarkets and convenience stores, as well as the above-noted
locations. From an economic perspective, whiskey and other imported beverages also prove to have low elasticity of demand in the above-mentioned countries. This, we propose, is due to the fact that consumers of these goods do so not just because of the enjoyment alcohol brings them.

In an upper-class community, both the bandwagon effect and snob effect contribute to the purchase of expensive goods. As proven, whiskey and Shochu are similar and DCS products, so, assuming the classic theory of demand, the relatively high price of whiskey compared to Shochu should lead to consumers buying only Shochu instead of imported alcohol.

However, sales of imported brown and white spirits remained stable in both Korea and Japan. We assert that this was not only due to consumer preferences (taste-wise), but also due to consumers purchasing imported alcohol simply because it was imported. Behaviorally, purchasing expensive products often creates a sense of pride, especially in view of a group of peers. This effect is adequately deemed “the snob effect.” When the snob effect is the predominant occurrence in a market, the demand curve tends to be less elastic than otherwise, as proven in both cases.

Another occurrence related to the snob effect is the bandwagon effect. Let us imagine characters A, B, C, and D, who’ve been friends for a short period of time. When A purchases an expensive (comparatively overpriced) product, in order to create an impression upon others instead of actually enjoying the product itself, they are demonstrating the snob effect. Their actions then pressure peers to perform the same act, for the sake of “coolness” or to “fit in.” Thus, B, C, D all begin purchasing expensive items that, no matter their preferences, conflict with the classic demand theory.

This was the case in Japan and Korea, where both countries were pressured to limit the importation of alcoholic beverages in order to protect the domestic Shochu and Soju market. However, we suggest that setting a “Liquor Tax Law” was not the most adequate way to do so, and thus we propose alternative solutions.

5.3 Alternative Options to Protect Domestic Market

Both Japan and Korea dealt with this offense to the domestic market with a Liquor Tax Law. We view this as an inadequate and lethargic solution that, in most cases, would violate GATT. The liquor taxes in both countries are ad valorem taxes which discriminate against countries, an approach clearly against the intentions of the GATT. First, we look at the aim of the Liquor Tax

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28 Which in fact was why both countries set Liquor Taxes on imported alcoholic beverages
Prior to Korea’s alcoholic beverage reform, domestic alcohol ruled the Korean market. However, after the reform, imported whiskey, vodka and other spirits gained quick popularity in Korea. For instance, between 1992 and 1996, the Korean market for whiskey increased from 315 million won to 880 million won. Clearly, this reform took away a (great) number of customers and demand for local alcoholic beverages. Thus Korea, based on its interpretation of demand theory, proceeded to increase the price of imported beverages, thinking it would lower demand. It didn’t work. On the other hand, an alternative approach Japan and Korea could have taken should have focused on legal measures designed to lower the net income of the exporting companies.

Similar approaches with identical aims which are GATT-legal would include:

1. Establishing a specific tax on distilled alcohol based on percentage of alcohol. This tax would be levied at the point of import, equally against all sources.

2. Establishing a domestic excise tax at retail. This tax would determine later taxes for higher alcoholic content.

3. The taxes raised by both mechanisms could be allocated to the domestic producers of less potent alcoholic drinks.

4. As an administrative mechanism, the importing country can direct all alcohol imports to enter the country at the port of entry X. The customs officials at that location would be overworked and understaffed.

5. Finally, the importing country can impose a more detailed labeling requirement to deal with health concerns about additives to distilled alcohol.

Specific taxes based on alcoholic content coupled with excise taxes also based on alcoholic content can address the question of raising the price of imported alcohol at both the point of entry (port) and the point of sales (retail). This tax will fall on those whose demand elasticity is low and thus would generate a substantial tax receipt. This tax receipt could then be redistributed to the domestic industry that the Government wants to protect.

This approach is GATT-legal and creates the required revenue for the domestic industry.

A second path both countries could have chosen to take would have involved setting up specific ports of entry for imports of alcoholic beverages. Alcoholic beverages imported to the country
would go through an exhaustive inspection which would take a long time. Technically, understaffing inspection locations or delaying the imports would result in a higher transaction cost to exporters.

We depend on the assumption that it would be impossible to change consumer preference by taxing these imported products due to the high inelasticity of demand for imported spirits in Japan and Korea. Nonetheless, that will generate the tax revenue to fund the direct subsidy for local producers. It would be possible to benefit domestic corporations while allowing demand for imported spirits. The above-mentioned procedures are totally GATT-legal, and would help local governments achieve the same effect of “protecting” the domestic market. With taxes acquired, money could be routed to local corporations making Shochu and Soju, and in turn, some could be used by governments for infrastructure improvements and to better manage the market for spirits.

Last but not least, the government would require content disclosures on labels for imported distilled spirits. Many companies add a variety of flavoring chemicals and adopt many filtering mechanisms in order to enhance the taste and quality of their spirits. A disclosure of non-natural ingredients would result in greater limits based on health issues. Such measures would push for the use of alternatives which are safe from a health standpoint. All of these measures would increase the costs to foreign exporters of distilled alcohol.

6. Conclusion

Ever since its creation, the GATT has strived for equality and fairness in trade for all members. In this paper, we used Japan and Korea as case examples in order to analyze the reasons demand exists, the line between DCS and “like,” the limitations and criteria of likeness, alternatives to internal taxes, and the efficacy of GATT as a whole. We suggest that an economic approach to product similarities regarding substitutability would be much simpler and less costly to enforce, both financially and legally. We also present a variety of alternatives that would achieve the same purpose as ad valorem taxes, but in a simpler and legal way.

Sections I to V contained, respectively, an introduction, a literature review, a case summary, a case law summary, and our own research and findings. This research revealed that all distilled spirits are physically highly similar, and that it is difficult to argue that end uses differentiate them. We also inferred from data presented in both cases that consumers, especially in East Asia, purchase imported alcoholic products not only because of price and taste, but also because of behavioral associations, such as the snob effect. Last but not least, we provided alternatives to
the illegal approaches that countries took in both cases, such as the imposition of specific taxes at points of entry, the employment of excise taxes at points of retail sales, and the establishment of specific ports of entry for alcohol inspection and labeling requirements. All of these measures could provide local producers of distilled alcohol with needed protection without violating GATT/WTO rules.

Bibliography


3. Carrere, Céline, and Jaime De Melo. “Notes on Detecting the Effects of Non-Tariff Measures.”


Appendix

1. Sales of Whiskey and Shochu

Annual Changes in Sales of Former Second Grade Whisky and Shochu

From Panel Report of Japan
2. Korea Liquor Tax & Education Tax

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

<table>
<thead>
<tr>
<th>Product</th>
<th>As % Liquor Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Diluted soju</td>
<td>10</td>
</tr>
<tr>
<td>Distilled soju</td>
<td>10</td>
</tr>
<tr>
<td>Whisky</td>
<td>30</td>
</tr>
<tr>
<td>Brandy</td>
<td>30</td>
</tr>
<tr>
<td>General distilled liquors</td>
<td>30</td>
</tr>
<tr>
<td>General distilled liquors containing whisky or brandy</td>
<td>30</td>
</tr>
<tr>
<td>Liqueurs</td>
<td>10</td>
</tr>
<tr>
<td>Other Liquors:</td>
<td></td>
</tr>
<tr>
<td>- more than 25% alcohol content</td>
<td>30</td>
</tr>
<tr>
<td>- less than 25% alcohol content</td>
<td>10</td>
</tr>
<tr>
<td>- containing whisky or brandy</td>
<td>30</td>
</tr>
</tbody>
</table>

30 From Panel Report of Korea
3. Retail Prices and Taxes of Alcohol in Japan\textsuperscript{31}

\begin{figure}
\centering
\includegraphics[width=\textwidth]{figure10.png}
\caption{Average Retail Prices and Taxes of Liquor (per a quantity containing the same amount of alcohol as a 750ml, 40\% bottle)}
\end{figure}

\textsuperscript{31}From the Panel Report of \textit{Japan}
Figure 11: Percentage of Taxes in Retail Prices

- Price net of tax
- Consumption Tax
- Liquor Tax

- Imported Brandy: 8%
- Imported Whisky: 15%
- Imported Rum: 12%
- Imported Vodka: 18%
- Imported Gin: 18%
- Domestic Shechu A: 22%
- Domestic Shechu B: 13%
- Imported Authentic Liqueur (at the current tax rate): 3%
- Imported Authentic Liqueur (at the pre-1989 tax rate): 5%