

**Japan - Taxes on Alcoholic Beverages**

*Arbitration  
under Article 21(3)(c) of the  
Understanding on Rules and Procedures  
Governing the Settlement of Disputes*

Award of the Arbitrator  
Julio Lacarte-Muró

## **I. Introduction**

1. On 1 November 1996, the Dispute Settlement Body (the "DSB") adopted (WT/DSB/M/25) the Appellate Body Report and the Panel Report, as modified by the Appellate Body Report, in *Japan - Taxes on Alcoholic Beverages* (WT/DS8/11, WT/DS10/11 and WT/DS11/8). As required by Article 21(3) of the *Understanding on Rules and Procedures Governing the Settlement of Disputes* (the "DSU"), Japan informed the DSB on 20 November 1996 of its intentions in respect of the implementation of the DSB's recommendations and rulings (WT/DSB/M/26). Japan indicated that it would not be able to implement immediately but only within a "reasonable period of time". Japan did not propose to the DSB a "reasonable period of time" for the latter's approval as provided for under Article 21(3)(a) of the *DSU*. It indicated that it would initiate negotiations with the European Communities, the United States and Canada, the other parties to the dispute, on what constitutes "a reasonable period of time". These negotiations did not succeed, and no mutual agreement within the meaning of Article 21(3)(b) of the *DSU* was reached. The negotiations with the European Communities did, however, lead to an agreement on an accelerated reduction of the tariff rates on whisky and brandy as compensation for delayed implementation, but this agreement does not prejudice their position on the issue of a "reasonable period of time".

2. In the absence of an agreement under Article 21(3)(b) of the *DSU*, the United States requested on 24 December 1996, that the "reasonable period of time" should be determined through binding arbitration as is provided for by Article 21(3)(c). After Japan and the United States failed to agree on the appointment of an arbitrator within the ten days envisaged by the note to Article 21(3)(c), the United States requested on 7 January 1997 that the Director-General appoint an arbitrator. Following consultations with the United States and Japan, the Director-General appointed me as arbitrator on 17 January 1997.

3. At an organizational meeting on 20 January 1997, it was agreed that all the original parties to the dispute could participate in the arbitration process, notwithstanding that only the United States had requested binding arbitration. It was further agreed that, in the circumstances of this case, the 90-day period provided for by Article 21(3)(c) of the *DSU*, which started on 1 November 1996, would not provide sufficient time for a full review of the matter. Accordingly, the parties agreed to extend the deadline for the arbitrator's award by two weeks, to expire on 14 February 1997. The parties gave written assurances that the arbitrator's award would nevertheless be accepted by them as "binding arbitration" within the meaning of Article 21(3)(c).

4. Written submissions were received from Japan and the United States on 27 January 1997. I requested certain additional information from Japan on 28 January 1997. Japan replied to this request

promptly, on 30 January 1997.

5. Having reached a political consensus on the necessary liquor tax amendments in mid-December 1996 after consultations with the government party (the Liberal Democratic Party) and with the interest groups concerned, the Government of Japan formally adopted its proposal for a Law to Amend a Portion of the Liquor Tax Law (Law No. 6, 1953) and submitted it to the Diet for approval on 31 January 1997, i.e. the deadline for proposals for new tax legislation. Throughout these arbitration proceedings, the Government of Japan has insisted that it would ordinarily be almost impossible to amend the draft legislation now before the Diet.

6. An oral hearing was held on 3 February 1997, and was attended by all four parties to the dispute.

## **II. The Proposed Implementing Legislation**

7. In the proposal currently before the Diet, the Government of Japan proposes to implement the recommendations and rulings of the DSB in *Japan - Taxes on Alcoholic Beverages* in three steps. In the first step, on 1 October 1997, Japan would reduce the tax rates on brown spirits (whisky, etc.), and increase the tax rates on Shochu A and Shochu B. The applicable rates would remain respectively greater and less than those levied on white spirits (vodka, etc.), i.e. the rate towards which all other rates are to converge. Liqueurs would be taxed at the same rates as white spirits. In the second step, on 1 October 1998, the rate of tax imposed on Shochu A would become equal to that levied on white spirits and liqueurs. The tax on brown spirits (whisky, etc.) would be further reduced, but would remain greater than that imposed on white spirits and liqueurs (i.e. 3% higher). The tax on Shochu B would be further increased, remaining less than that imposed on white spirits and liqueurs. In the third step, on 1 October 2001, Japan would increase the tax rate on Shochu B to the level imposed on white spirits and liqueurs.

8. The proposed amendments to the Liquor Tax Law would implement the recommendations and rulings of the DSB within 23 months of 1 November 1996, except insofar as they apply to Shochu B. With regard to Shochu B, the increase of the tax would be implemented in three stages<sup>1</sup> and full compliance with the DSB's recommendations and rulings would be attained by 1 October 2001, i.e. within five years.

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<sup>1</sup>On 1 October 1997, the tax on Shochu B would be increased from 102,100 Yen/kilolitre of alcohol to 150,700 Yen/kilolitre, on 1 October 1998 to 199,400 Yen/kilolitre and finally on 1 October 2001 to 248,100 Yen/kilolitre.

### **III. The Legal Framework**

9. As a general and fundamental obligation imposed on all WTO Members, Article XVI:4 of the *Marrakesh Agreement Establishing the World Trade Organization* (the "*WTO Agreement*") requires that each Member shall ensure the conformity of its laws, regulations and administrative procedures with its obligations as provided in the *WTO Agreement*. To preserve the rights and obligations of Members under the *WTO Agreement*, the WTO provides for a dispute settlement system that is set out in the *DSU*.

10. As basic principles of WTO dispute settlement, Article 3(3) of the *DSU* stipulates that:

The prompt settlement of situations in which a Member considers that any benefits accruing to it directly or indirectly under the covered agreements are being impaired by measures taken by another Member is essential to the effective functioning of the WTO and the maintenance of a proper balance between the rights and obligations of Members.

and Article 3(7) of the *DSU* states that:

In the absence of a mutually agreed solution, the first objective of the dispute settlement mechanism is usually to secure the withdrawal of the measures concerned if these are found to be inconsistent with the provisions of the covered agreements.

11. Article 21(1) of the *DSU* stipulates that "*prompt compliance* with recommendations and rulings of the DSB is essential in order to ensure effective resolution of disputes to the benefit of all Members" (emphasis added). This obligation is further elaborated in Article 21(3) of the *DSU*, where it is stipulated that "if it is impracticable to comply *immediately* with the recommendations and rulings, the Member concerned shall have a reasonable period of time in which to do so" (emphasis added). When this "reasonable period of time" is determined through binding arbitration as provided for under Article 21(3)(c) of the *DSU*, this provision states that a "guideline" for the arbitrator should be that the "reasonable period of time" should not exceed 15 months from the date of the adoption of a panel or Appellate Body Report. Article 21(3)(c) of the *DSU* also stipulates, however, that the "reasonable period of time" may be shorter or longer than 15 months, depending upon the "particular circumstances". The term, "particular circumstances", is not defined in the *DSU*.

### **IV. Arguments of the Parties**

*United States*

12. With regard to what constitutes the "particular circumstances" which need to be taken into account when determining the "reasonable period of time" for the purpose of Article 21(3)(c) of the *DSU*, the United States argues that only the following are relevant:

- (a) the type (legislation, regulation, decree, etc.) and technical complexity (e.g. making a simple change in a tariff rate, as compared to making more complex changes like the development of a new scientific standard) of the measures that the Member must draft, adopt and implement; and
- (b) the minimum period of time in which the Member can achieve implementation, assuming that the Member acts in good faith.

13. According to the United States, the question of "particular circumstances" does not, therefore, imply a policy judgement, but rather a technical inquiry into the domestic legislative or regulatory system in the Member country concerned. Domestic political, economic and social considerations should not be taken into account. The United States asserts that hardship of an economic and/or social nature and political tension are inevitable whenever a government proposes to end its protection of a domestic industry. The United States argues that if such considerations are taken into account, this would threaten the integrity of the WTO dispute settlement system. The question for the arbitrator is what is the shortest period of time in which implementation can practicably take place, not whether a longer period of time would make implementation less burdensome and painful for the implementing Member.

14. Applying these general considerations in this particular case, the United States argues that it would be reasonable to determine that Japan can implement the necessary tax changes in April 1997, i.e. five months from the adoption of the DSB's recommendations and rulings. The United States suggests this period because:

- (a) it falls within the one to six-month period that Japan allegedly claimed it generally needed to change indirect taxes;
- (b) it is more than adequate to achieve the simple amendment to the Liquor Tax Law needed to change tax rates on alcoholic beverages;
- (c) the Diet normally enacts fiscal measures in March each year; and
- (d) it is the beginning of Japan's fiscal year when tax changes are routinely implemented.

15. The United States also points out that Japan has demonstrated in the past that it is capable of implementing changes to its Liquor Tax Law in a short period of time. The amendment to the Liquor

Tax Law passed on 10 April 1984 came into effect 20 days later, and the legislation which was adopted in implementation of the 1987 GATT panel on *Japan - Customs Duties, Taxes and Labelling Practices on Imported Wines and Alcoholic Beverages*<sup>2</sup> and which involved more sweeping reforms, was implemented in just over three months following the passage of the bill.

16. More generally, the United States asserts that WTO Members have a strong interest in establishing an example of prompt compliance with, and full implementation of, the DSB's recommendations and rulings. Although it would be hypothetically possible to reach an immediate settlement that would partially offset some of the commercial losses associated with the deficiencies in Japan's proposed implementation, the United States maintains that such a settlement would not address the competitive harm produced by a continuing national treatment violation. The United States also suggests that the failure of Japan, as one of the world's leading trading nations, to comply fully and in a timely manner with the DSB's recommendations and rulings would be damaging to the credibility of the WTO dispute settlement system. The United States believes that allowing for a 5-year "reasonable period of time" would have a devastating impact on the dispute settlement system.

#### *Japan*

17. Japan agrees that, in general, the "reasonable period of time" should be determined in light of the *DSU's* general objective of prompt compliance, but it notes that the *DSU* is also very clear in allowing for flexibility. Japan stresses that although Article 21(3)(c) of the *DSU* indicates that 15 months is a guideline for the arbitrator to award for implementation, this period of time can be extended if "particular circumstances" exist. Japan considers that nowhere in the *DSU* are there any provisions which prescribe the scope of the "particular circumstances" to be considered and argues that each and every circumstance relevant to each individual case should be carefully examined. Japan considers that in the present case, a 23-month period for implementation is a "reasonable period of time" because there are a number of "particular circumstances" justifying such a period.

18. First, Japan invokes, as a relevant "particular circumstance", the limited powers of the executive branch over taxation and the need for formal legislation adopted by the Diet in order to implement the recommendations and rulings of the DSB. Since the proposed amendments involve drastic increases in the taxes on shochu and are, therefore, very unpopular and have met with considerable political opposition, the procedure for preparing and adopting these amendments has been and will be difficult and complex. Adding to the difficulty and complexity of the legislative process is the fact that the current government does not have a majority in either Chamber of the Diet.

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<sup>2</sup>BISD 34S/83, adopted on 10 November 1987.

19. Secondly, Japan invokes, as a relevant "particular circumstance", the adverse effects of the tax increases on Japanese consumers and shochu producers. Under the proposed tax reform, the tax on Shochu A will be increased by 1.6 times and on Shochu B by 2.4 times. Japan contends that a 2.4 times increase, without staging, would be unprecedented in the history of any developed country. Japan argues that in order to mitigate the adverse impact of the liquor tax increases on consumers and producers, it is only normal to spread these increases over time. Japan recognizes that this was not done for the 1989 liquor tax increases, but submits that the situation was different then. The tax increases were less drastic and also affected the competing saké. In addition, shochu producers received more financial support in the context of the implementation of the 1987 Panel Report.

20. Furthermore, Japan points out that in April 1997, there will already be a very substantive increase in the consumption tax, which was decided in November 1994, and that it would be unacceptable for the liquor tax increases and the consumption tax increase to be carried out simultaneously. Japan also points out that large-scale increases in taxes normally take place in one-year intervals to mitigate the impact on consumers. Thus, as the consumption tax will take effect on 1 April 1997, the liquor tax increases should normally become effective one year later, on 1 April 1998. Since this would, however, have brought the first stage of the liquor tax amendments beyond the 15-month "reasonable period of time", Japan has proposed to bring forward the first stage of the implementation to 1 October 1997 (i.e. 11 months after the DSB decision). According to Japan, this represents a major effort on its part, and an indication that Japan takes the Article 21(3)(c) guideline of 15 months very seriously. In this context, Japan also argues that by bringing forward the first stage of implementation (from 1 February 1998, i.e. 15 months after the DSB decision, to 1 October 1997, i.e. 11 months after the DSB decision), an advantage is created for importers that is equivalent to the disadvantages arising from the fact that the implementation is not fully realized within 15 months.

21. Finally, Japan invokes, as a relevant "particular circumstance", the administrative constraints on the execution of taxation. The proposed changes in the tax system will have to be notified and explained to 180,000 wholesalers and retailers in advance and this notification alone will take a considerable amount of time. Furthermore, Japan argues that liquor distributors will need time to adjust their computer programmes and advertising material.

22. As an important factor underlying the arguments set out above, Japan invokes the rigidity of the domestic process for the adoption of the annual budget. Under this process, the government decides, after intensive consultations with the government party, on the contents of any tax reform in mid-December in order to be able to submit to the Diet the draft budget and all proposals for tax legislation by the end of January. During the oral hearing, Japan indicated that if this timing is missed, the tax

legislation concerned can ordinarily no longer be amended for the following fiscal year. The Diet is unwilling to consider draft tax legislation outside of this time schedule.

23. As mentioned above, with regard to Shochu B, full compliance with the DSB's recommendations and rulings would, under the current Japanese proposal for tax reform, only be attained in October 2001, i.e. after five years. Japan does not argue that this 5-year period constitutes a "reasonable period of time" within the meaning of Article 21(3)(c) of the *DSU*. To compensate for the delayed implementation, Japan has, therefore, offered the European Communities, the United States and Canada an accelerated reduction of the tariff rates on alcoholic beverages as negotiated in the context of the Uruguay Round. The European Communities have accepted this offer but the United States and Canada have not. Furthermore, Japan argues with regard to Shochu B that the tax differential remaining in the period between October 1998 and October 2001 will not have adverse effects on imported whisky or brandy in practice, because this tax differential will already have been significantly reduced from its current level. Japan suggests that any negative impact on imported whisky or brandy will be further minimized by the fact that the majority of Shochu B is consumed in a limited region in the south of Kyushu Island. This argument is strongly contested by the United States which submits that all the information it has received from its producers of alcoholic beverages points to the contrary.

24. Japan argues that the reasonable period of time for implementation of the DSB's recommendations and rulings should not be influenced by circumstances surrounding the earlier dispute concerning the Liquor Tax Law that resulted in the 1987 Panel Report. According to Japan, therefore, the present matter should be examined in its own context, and in the light of the "particular circumstances" described above. The United States, on the other hand, does refer to the 1987 Panel Report to demonstrate that it is possible for Japan to implement changes to its Liquor Tax Law within a considerably shorter period than proposed by Japan in this case.

*European Communities and Canada*

25. Without taking a position on the question whether or not 23 months is, in the present case, a "reasonable period of time", the European Communities state that in general the "reasonable period of time" should be 15 months.

26. Canada, on the contrary, takes the position that 23 months and certainly 5 years are not "reasonable periods of time". It does not consider the "particular circumstances" advanced by Japan to be relevant. Canada notes furthermore that "particular circumstances" are always unique and should not be construed as having precedential value for future cases. Finally, Canada notes that Japan appears to be suggesting that a longer period of time (five years) is required with respect to Shochu B because the

tax differential that needs to be eliminated is so much greater than with respect to Shochu A. This is tantamount to arguing, Canada observes, that the greater the degree of inconsistency with WTO obligations, the greater the period of time a Member should be granted to bring that measure into conformity with the *WTO Agreement*.

**V. Award**

27. As stated in Article 3(2) of the *DSU*, the dispute settlement system of the WTO is a central element in providing security and predictability to the multilateral trading system. Therefore, all WTO Members have a strong interest in prompt compliance with and full implementation of the recommendations and rulings of the DSB. This interest is clearly reflected in the provisions of the *DSU*, and in particular in Article 21(3)(c), which stipulates that a "reasonable period of time" for implementation should not exceed 15 months unless there are "particular circumstances" justifying a longer or shorter period. In this case, I am not persuaded that the "particular circumstances" advanced by Japan and the United States justify a departure from the 15-month "guideline" either way. I conclude, therefore, that a "reasonable period of time" within the meaning of Article 21(3)(c) of the *DSU* for Japan to implement the recommendations and rulings of the DSB of 1 November 1996 in *Japan - Taxes on Alcoholic Beverages* is 15 months.

Signed in the original, at Geneva, this 13th day of February 1997 by:

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Julio Lacarte-Muró