

CHILE – TAXES ON ALCOHOLIC BEVERAGES

Report of the Panel

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Note by the Secretariat: This Panel Report shall be adopted by the Dispute Settlement Body (DSB) within 60 days after the date of its circulation unless a party to the dispute decides to appeal or the DSB decides by consensus not to adopt the report. If the Panel Report is appealed to the Appellate Body, it shall not be considered for adoption by the DSB until after the completion of the appeal. Information on the current status of the Panel Report is available from the WTO Secretariat.

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	1,640.8	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.

[Parties' arguments in Sections IV and V deleted from this version]

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 unrebutted 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.

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:

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.

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:

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

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."

³⁵¹ Appellate Body Report on *Japan - Taxes on Alcoholic Beverages II*, *supra.*, p.16.

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.

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*

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.

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 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

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*").

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 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

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.

³⁶² Panel Report on *Korea – Taxes on Alcoholic Beverages*, *supra.*, para. 10.50.

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 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.

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.

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.

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

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.

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.

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 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

³⁷¹ See Table 23 in Descriptive Part of this Report.

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.

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.

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.

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:

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.

"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

(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.

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.

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 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.

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.

³⁸⁵ See EC First Submission, Table 19.

³⁸⁶ *Ibid.*, Table 17.

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

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%

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 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.).

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 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

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.

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.

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 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

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.

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

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

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;

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.

- (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.

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

⁴⁰² See Kelvin J. Lancaster, "A New Approach to Consumer Theory", in *Journal of Political Economy*, Vol. LXXIV (April 1966), pp. 132-157.

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:

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:

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.

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.

[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 un rebutted 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.

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

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 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.

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 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 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

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.

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.

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 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.

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.

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 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

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.

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.

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 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:

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.

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.

[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.

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.

⁴²⁵ Appellate Body Reports on *Canada – Periodicals*, *supra.*, p. 31.

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 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

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.

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.

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 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

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.

⁴³⁰ See Report, para. 4.399, Chile Second Submission, para. 28 and Chile's Statement at the Second Meeting, paras. 26-31.

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.

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*,

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.

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 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

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.

⁴³⁶ See EC Answers to Question C. 4 and EC Exhibit 62.

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 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

⁴³⁷ We note that, for most types of spirits, the New Chilean System will actually increase the discrimination against them compared to pisco.

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.

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.

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.

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.
