

Korea - Taxes on Alcoholic Beverages

Report of the Panel

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I. PROCEDURAL BACKGROUND

1.1. This proceeding has been initiated by two complaining parties, the European Communities and the United States.

1.2. On 2 April 1997, the European Communities requested consultations with Korea under Article XXII:1 of GATT and Article 4 of the Understanding on Rules and Procedures Governing the Settlement of Disputes ("DSU") (WT/DS75/1). The United States (WT/DS 75/2) and Canada (WT/DS75/3) requested to be joined in those consultations, pursuant to Article 4.11 of the DSU on 17 and 21 April 1997, respectively. Korea agreed to those requests (WT/DS75/4 and WT/DS75/5). Consultations between the European Communities and Korea were held in Geneva on 29 May 1997, in which the United States and Canada participated.

1.3. On 23 May 1997, the United States requested consultations with Korea under Article XXII:1 of GATT and Article 4 of the DSU with respect to the same matter (WT/DS84/1). Canada (WT/DS84/2) and the European Communities (WT/DS84/3) requested to be joined in those consultations, pursuant to Article 4.11 of the DSU, on 29 May and 5 June 1997, respectively.

1.4. Consultations were held in Geneva on 24 June 1997, between the United States and Korea, and the European Communities and Canada participated as third-parties. Another set of consultations were held on 8 August 1997, to address US requests for further clarifications, but the parties were unable to settle the dispute.

1.5. On 10 September 1997, the European Communities (WT/DS75/6), and the United States (WT/DS84/4), each requested the establishment of a panel pursuant to Article 6.1 of the DSU.

1.6. In its panel request, the European Communities claims that:

Korea, by according a preferential tax treatment, through the Liquor Tax Law and the Education Tax Law, to soju vis-a-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 the GATT 1994.

1.7. In its panel request the United States claims that:

Korea, under its general Liquor Tax Law, imposes a lower tax on the traditional Korean distilled spirit soju than the high taxes it applies to other distilled spirits such as whisky, brandy, vodka, rum, gin and "ad-mixtures". This difference in tax burden is made even more dramatic by the application of an Education Tax.

1.8. The Dispute Settlement Body (DSB) agreed to these two requests for a panel at its meeting of 16 October 1997, establishing a single panel pursuant to Article 9.1 of the DSU with the following standard terms of reference:

"To examine, in light of the relevant provisions of the covered agreements cited by the European Communities in document WT/DS75/6 and the United States in document WT/DS84/4, the matter referred to the DSB by the European Communities and the United States 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".

1.9. Canada and Mexico reserved their rights to participate in the Panel proceedings as third-parties.

1.10. On 26 November 1997, the United States and the European Communities jointly requested the Director-General to determine the composition of the panel, pursuant to paragraph 7 of Article 8 of the DSU. On 5 December 1997, the Director-General composed the Panel as follows:

Chairman: Mr. Åke Lindén

Panelists: Professor Frédéric Jenny

Mr. Carlos da Rocha Paranhos

1.11. The Panel had substantive meetings with the parties on 5 and 6 March 1998, and on 21 and 22 April 1998.

II. MEASURES IN ISSUE

2.1. Korea maintains a multi-tiered taxation regime on the sale of alcoholic beverages. Under the Liquor Tax Law of 1949, as amended, Korea creates various categories of distilled spirits, on which it imposes different *ad valorem* taxes. Under the Education Tax Law of 1982, as amended, Korea assesses a surtax on certain of these sales, determined as a percentage of the established liquor tax.

2.2. Both the liquor tax and the education tax on alcoholic beverages are imposed at the wholesale level. The tax is payable by the manufacturer of the beverages or, in the case of imports, by the importer. Tax liability accrues at the time of shipment from the factory (in the case of alcoholic beverages made in Korea) or of withdrawal from the bonded warehouse (in the case of imported alcoholic beverages).

A. THE LIQUOR TAX LAW

2.3. The Liquor Tax Law lays down a system of excise taxes applicable to all alcoholic beverages (whether manufactured in Korea or imported) intended for consumption in Korea. The taxes applied to the categories in dispute are in the form of *ad valorem* taxes.

2.4. For the purposes of assessing the tax, the value of imported alcoholic beverages includes transport and insurance costs as well as the import duty imposed. In other words, the tax base for imports is the price noted on the import declaration when the goods are withdrawn from the bonded warehouse (i.e., the CIF import value plus duty).¹

2.5. Domestic alcoholic beverages are taxed on the value of production costs, sales costs (including advertising), extraordinary costs, and profits, i.e., the tax base is the price of the goods when they are shipped from the production site.² The categories of distilled spirits established by the Liquor Tax Law, and the applicable tax rates, are described below.

1. Categories

2.6. Liquor Tax Law divides alcoholic beverages into eleven categories, some of which are further divided into sub-categories, and assigns to each of them a different tax rate. These categories include "soju," "whisky," "brandy," "general distilled liquors" (which covers beverages such as vodka, gin, rum and tequila), "liqueurs," and "other liquors" (to the extent that liquors falling within this category may contain distilled spirits or liqueurs falling within any of the preceding categories). Article 3 of the Liquor Tax Law sets forth definitions of these categories.³

(a) Soju

2.7. Article 3.6 has four sub-categories of soju. Sub-categories A and B apparently refer to "distilled soju," while sub-categories C and D apparently refer to "diluted soju."

2.8. Article 3.6.A and 3.6.B states the legal definition of soju as:

- (a) Soju may be produced from discontinuous distillation of a fermented mash developed from the basic constituents of a starch source, yeast and water.

¹ Article 19.2 of the Liquor Tax Law.

² Presidential Decree, Article 26.

³ A translation of the relevant provisions of Article 3 is provided as US Exhibit A.

- (b) Soju may be produced from discontinuous distillation as in Paragraph A above, but during the fermentation and production process other ingredients may be added as determined by Presidential decree.

2.9. Thus paragraphs (A) and (B) describe two "types" of soju: (i) soju created by fermentation and discontinuous distillation, but without additives; and (ii) soju created by fermentation and discontinuous distillation and containing additives.

2.10. According to Article 3.6.A, distilled soju cannot

- (a) be produced from sprouted grain;
- (b) be filtered through charcoal of white birch; or
- (c) be produced in a process whereby water is mixed with grain and the mash sealed for fermentation and subsequent distillations.

2.11. The chapeau of Article 3.6 specifies that soju must have an extract content of 2% or less.

2.12. The legal definition of diluted soju in Article 3.6.C and 3.6.D is as follows soju:

- (a) Soju may be produced by diluting neutral spirits with water or by adding thereto those ingredients as determined by Presidential Decree;
- (b) Soju may be produced by adding to the products produced in accord with paragraphs A through C immediately above the product of paragraph A, when determined by Presidential Decree, or other grain spirits as determined by Presidential Decree.

2.13. The definition of diluted soju in 3.6.C and D relies on "neutral spirits," which is defined by Article 3.1 of the Liquor Tax Law as follows:

- (a) Neutral spirits may be produced from the distillation of a fermented mash developed from the basic constituents of a starch source and a sugar source that results in a product that is 85 percent or more alcohol;
- (b) Neutral spirits may be produced from the distillation of ingredients containing alcohol, resulting in a product that is 85 percent or more alcohol.

(b) Whisky, brandy, and "general distilled liquors"

2.14. Whisky, brandy and "general distilled liquors" are defined in Articles 3.7, 3.8 and 3.9, respectively. The definitions include a 2% extract limitation that distinguishes them from liqueurs. All three include fermentation and distillation as the manufacturing process. However, unlike the definition for soju, they generally specify starch sources.

2.15. Article 3.7 of the Liquor Tax Law, the "whisky" category, includes all types of whisky made totally or partly from sprouted grain and aged in wooden casks, as well as, under certain conditions, admixtures of whisky and other spirits or ingredients.⁴

⁴ See Article 3.7 of the Liquor Tax Law. The whisky definition includes three subparagraphs. Paragraph (A) specifies only sprouted grains and thus addresses malt whisky. Paragraph (B) appears to broaden the starch source to normal grain as well as sprouted and thus addresses ordinary grain whisky. Both (A) and (B) provide for aging in wooden barrels and thus address premium brands of whisky. Paragraph (C) addresses

2.16. Article 3.8, the "brandy" category, includes all liquors distilled from a fermented mash of fruit or fruit wine and aged in wooden casks. Subject to certain conditions, it includes also admixtures of those liquors with other spirits or ingredients.⁵

2.17. The category of "General Distilled Liquors" is a miscellaneous category comprising several kinds of distilled spirits. It consists of six paragraphs.

- Paragraph (A) specifies kaoliang-ju lees as a starch source, and the manufacturing process includes sealing prior to fermenting and distilling; it is designed to address *kaoliang-ju*, which can be imported from China.
- Paragraph (B) specifies sugar cane, sugar beet, sugar, and/or molasses as a starch source; it addresses *rum*.
- Paragraph (C) specifies "fruits of juniper tree" as an ingredient; it addresses *gin*.
- Paragraph (D) specifies filtering of the alcohol; it addresses *vodka*.
- Paragraph (E) merely concerns "materials mainly containing starch or sugar produced by fermentation and distillation." It covers *tequila* and any distilled spirit. Its wording is the same as that used in the first part of the definition of "neutral spirits".⁶
- Paragraph (F) addresses *mixed distilled drinks* (e.g., gin and rum mixed drinks).

(c) Liqueurs

2.18. Article 3.10, the "liqueurs" category, covers liquors with more than 2% extract content produced by distillation of a starch or sugar source to which ginseng juice, fruits or fruits extracts are added.⁷

2.19. Article 3.11 sets forth the category of "other liquors," a residual category including all liquors (whether fermented or distilled) not falling within any of the other categories defined by the Liquor Tax Law.⁸ It includes *inter alia* admixtures of whisky and brandy.

premium blended whisky and/or whisky with sugars, acids, seasonings, fragrances, colouring, or carbon dioxide added.

⁵ See Article 3.8 of the Liquor Tax Law.

⁶ See Article 3.1 of the Liquor Tax Law.

⁷ See Article 3.10 of the Liquor Tax Law.

⁸ See Article 3.11 of the Liquor Tax Law.

2. Tax rates

2.20. The Korean law imposes different *ad valorem* tax rates on the various categories and sub-categories of distilled spirits. Pursuant to the definitions, soju is given a tax rate of 35 to 50 percent, while other distilled alcoholic beverages are taxed at 80 to 100 percent. The applicable liquor tax rates are:⁹

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

B. THE EDUCATION TAX LAW

2.21. The Education Tax Law of 1990 is assessed as a surtax on the sale of a variety of items, including most alcoholic beverages. For alcoholic beverages, the applicable rate is determined by reference to another tax -- the applied liquor tax rate.¹⁰ For those assessed a liquor tax rate of 80% or greater, the law imposes an education surtax calculated as 30% of the liquor tax imposed.¹¹ For alcoholic beverages assessed a liquor tax rate of less than 80%, the law imposes an education surtax calculated as 10% of the liquor tax imposed.

⁹ The applicable tax rates are set forth in Article 19.2, and Korean Taxation: 1997, § 3(b) p. 188 (Korean Ministry of Finance and Economy).

¹⁰ In addition to the liquor tax, other taxes upon which the Education Tax is levied include the Special Excise Tax, the Per Capita Inhabitant Tax, the Registration Tax, the Horse Race Tax, the Property Tax, the Aggregate Land Tax, the Tobacco Consumption Tax, the Automobile Tax and the Transportation Tax.

¹¹ Education Tax Law, Art. 5.

2.22. This tax structure results in a 30% surtax for imported distilled alcoholic beverages, including whisky, brandy and general distilled liquors (vodka, rum, gin, tequila, shochu, etc.) except for imports of Japanese shochu, which are classified for tax purposes and taxed at 10%. Of all distilled alcoholic beverages, only soju and liqueurs are subject to the lesser 10% surtax. Prior to 1995, soju was exempted from the Education Tax. However, after negotiations between Korea and the European Communities that Korea agreed to subject soju to the Education Tax at a rate of 10%.

2.23. The applicable rates on the categories concerned by this dispute, expressed as a percentage of the amount payable pursuant to the Liquor Tax, is as follows:

| Tax rates applied pursuant to the Education Tax Law | |
|--|-----------------|
| Product | As % Liquor Tax |
| Diluted soju | 10 |
| Distilled soju | 10 |
| Whisky | 30 |
| Brandy | 30 |
| General distilled liquors | 30 |
| General distilled liquors containing whisky or brandy | 30 |
| Liqueurs | 10 |
| Other Liquors: | |
| -more than 25% alcohol content | 30 |
| -less than 25% alcohol content | 10 |
| -containing whisky or brandy | 30 |

[Parties' arguments in Section III deleted from this version]

IV. CLAIMS OF THE PARTIES

4.1. The European Communities claims that:

- (i) Korea is in breach of its obligations under GATT Article III:2, first sentence, by applying internal taxes on imported vodka pursuant to the Liquor Tax Law and the Education Tax which are in excess of those applied on soju; and
- (ii) Korea is in breach of its obligations under Article III:2, second sentence, by applying higher internal taxes pursuant to the Liquor Tax Law and the Education Tax Law on imported liquors falling within the categories of 'whisky', 'brandy', 'general distilled liquors', 'liqueurs', and 'other liquors' (to the extent that they contain other distilled spirits or liqueurs) than on soju, so as to afford protection to its domestic production of soju.

4.2. The United States claims that the Korean laws outlined above differentiate among distilled spirits on the basis of arbitrary characteristics, resulting in great disparities in the treatment of soju and imported distilled spirits. According to the United States, at the very minimum:

- (i) Korea's application of internal taxes on vodka that exceed taxes applied to soju is inconsistent with the first sentence of GATT Article III:2; and
- (ii) Korea's application of higher internal taxes to imported distilled spirits classified under HS heading 2208 falling within its legal categories of "whisky," "brandy," "general distilled liquors," "liqueurs" and "other liquors" (to the extent that they contain other distilled spirits) afford protection to its domestic production of soju, inconsistent with the second sentence of Article III:2.

[Parties' arguments and answers to questions in Sections V through VIII deleted from this version]

IX. INTERIM REVIEW

9.1. In letters dated 7 July 1998 the European Communities, the United States and Korea all requested an interim review by the panel of certain aspects of the Interim Report issued to the parties on 26 June 1998. The requests dealt with certain aspects of the descriptive portion of the Interim Report including the summaries of the arguments as well as with the Findings. None of the parties requested a further meeting with the Panel.³²⁷

9.2. The major issue of concern of the parties with the descriptive portion (other than some individual and technical points which we have accommodated) was inclusion of the oral statements of the parties. In the initial version of the descriptive portion of the report, little was included from the oral statements. Oral statements generally are intended to be summaries of the written statements, not presentations of new evidence or arguments. Nonetheless, we have accommodated the requests as appropriate. However, we must note a particular difficulty in this regard in accommodating some of the comments of the United States. In part of the comments, the United States did not request specific portions of their oral statements to be included in specific spots in the descriptive portion. Instead, the United States offered a redrafting of its arguments that effectively recast whole portions of their presentation.

9.3. We have taken note of the implicit approach of the United States that parties to a dispute should submit draft summaries of their arguments for inclusion in the descriptive portion of a panel report. However, this is an approach that should be agreed with all the parties at the outset of a proceeding rather than made by one party at the close of the proceedings. Future panels may wish to adopt such an approach. Unfortunately, no suggestions were made and no discussion of this approach was held at an early stage of these such proceedings. Therefore, we cannot accept the wholesale changes requested by the United States. Instead, we attempted to include in the descriptive part some of the sections of the U.S. oral statements reflecting the issues identified by the United States.

9.4. With respect to the Findings, the European Communities requested language changes in several paragraphs. We agree with most of the recommended changes as clarifications of the existing language and have amended paragraphs 10.43, 10.53, 10.100 and 10.101, accordingly.

9.5. The European Communities disagreed with the finding in paragraph 10.57 that the complainants provided "no evidence whatsoever" with respect to distilled alcoholic beverages not identified during the course of the proceedings. The EC's argument is that they have identified physical characteristics and end-uses common to all distilled alcoholic beverages and, therefore, that all such beverages identified in HS classification 2208 should be included. These general statements included very weak evidence with respect to products not even identified. In addition, these other beverages were not even included in the Dodwell study. Economic studies such as the Dodwell study are not necessary, but they are very useful. In other words, such market surveys are a source of information, not a limitation. Paragraph 10.57 has been amended to clarify this point.

9.6. The United States made a number of recommended changes in language that we agree provides greater clarity to the existing language. Therefore, we have amended the language in paragraphs 10.1, 10.41, 10.42, 10.43, 10.47, 10.51, 10.74, 10.95, 10.97, 10.100 and 10.101, accordingly.³²⁸

³²⁷ The Interim Report constitutes Section IX of the Final Panel Report. Inclusion of this section makes the Findings portion of the Report Section X. References to paragraph numbers and comments of the parties have been adjusted accordingly.

³²⁸ The United States made a reference to paragraphs 10.42-10.43 in one comment. We assume they were referring to paragraphs 10.41-10.42.

9.7. The United States requested changes in paragraphs 10.18 and 10.23 to the effect that the issues covered in those paragraphs should be decided on the basis that the Korean requests were not within the panels terms of reference. We disagree with the US position. Under the US interpretation, many jurisdictional and other issues affirmatively raised by respondents would by definition be outside the terms of reference of a panel because the terms of reference are defined by the substantive issues raised in the complaining party's request for establishment of a panel. We think any panel has the right and obligation to address fundamental jurisdictional questions and issues relating to the proper functioning of the panel raised by any party to the dispute. Accordingly, we declined to change the basis of our decision in this regard.

9.8. The United States requested we delete paragraph 10.39 relating to discussions during the original negotiating sessions. This paragraph deals with a hypothetical and does not draw any conclusions about the specific products that were discussed in 1947-48. Rather, it was the nature of the discussion and what the discussion itself brought to light about the interpretation of *Ad Article III:2* which is of relevance. We do not reach a legal or factual conclusion that "such products could not compete 'directly' under Article III." We have amended the language of 10.39 to provide further clarification.

9.9. The United States requested that the panel eliminate the two sentences at the end of the footnote in paragraph 10.42. In our view, the first sentence is a useful clarification. The second sentence has been eliminated.

9.10. The United States recommended changing the fourth sentence of paragraph 10.48. We assume the United States is referring to the fifth sentence. However, it is obvious from the whole paragraph that we are discussing methodology, not the facts of the Korean market. Therefore, we have declined to amend the paragraph.

9.11. With respect to paragraphs 10.55-10.57, the United States argued that classification under the same tariff heading is in itself evidence that products compete directly. We do not agree with the characterization of the issue proposed by the United States. The products first must be properly identified. As we noted above in regard to the EC's comments, these general statements are very weak evidence at best. The US argument also somewhat begs the question because there is a related issue of what level of detail in the tariff headings is appropriate for such analysis in any given case. The problem in this case is that we were left uninformed about what products constitute the remainder of the category. We declined to make the changes suggested by the United States in this regard beyond the clarification mentioned with respect to the EC comments above.

9.12. With respect to paragraph 10.81, the United States requested several changes for purposes of clarification. We have eliminated one sentence as redundant, but have otherwise kept the original language.

9.13. Korea stated that it had great difficulty accepting the outcome of the case. In Korea's view, the complainants failed to prove the necessary elements to establish a violation of Article III:2. In its General Comments, Korea states, among other things, that soju is consumed "primarily" with meals and that whisky and other spirits are consumed "primarily" as cocktails. We note as a general matter that Korea was drawing far too fine a distinction between end-uses for purposes of Article III:2, second sentence. We note that, even in Korea's approach (which we do not accept), it is only a matter of the "primary" use where there are differences. There are overlapping end-uses even within the Korean definition.

9.14. Korea further states that "Korea finds it difficult to accept that the Panel puts into doubt Korea's description of its own market". Korea implies that any party to a dispute has an exclusive authority to assess the facts relating to its domestic market. We find no support for such a proposition

in GATT/WTO jurisprudence. Indeed, that is the very function of a panel in a case such as this, to assess the facts and arguments and make findings based on a weighing of the evidence presented.

9.15. In its General Comments section Korea also made the specific comment that it did not argue that western-style liquors were found in "expensive restaurants" but soju was not. However, we note that in writing its comments, Korea in fact described the restaurants referred to by the United States that served whisky as well as soju as "expensive" restaurants.³²⁹ This also is how Korea referred to these establishments during the Second Meeting of the Panel. These establishments were not offered as a representative sample and we did not view them that way. Rather, we reviewed all of the arguments of all of the parties and took account of and balanced all of the evidence presented. Arguments here and elsewhere that the Panel "relied" upon any particular piece of evidence or assessment must be evaluated in that light. Korea examines in too isolated a manner the various other factors assessed by us in reaching our conclusions. Ultimately, we relied upon all of the evidence presented, not any single element. In our view, the arguments at that time and in the Korean comments on the Interim Report were not persuasive, in light of all the evidence, in rebutting the case established by the complainants.

9.16. With respect to paragraph 10.45, Korea emphasized that an analysis of the particular market in question is required. We agree. However, as stated in the Findings, that does not imply that evidence of product relationships from other markets is irrelevant to an assessment of the competitive relationship of the products in the market in question. It is a matter of utilization and weighing of the evidence. Korea then states that it is relevant to look at how Korean manufacturers market shochu and soju in Japan and argues that there are differences. We do not disagree that there are some differences between soju and shochu, but, in our view, the differences are minor and we disagree that such differences contradict our conclusions with respect to the Korean market.³³⁰ We also note that the Korean companies have created products and advertised them in Korean and international markets that emphasize the similarity of soju to western-style beverages which is the question here. We took into account the evidence presented by Korea with respect to soju and shochu. As part of our weighing of the evidence, we also took note of other information from outside of the Korean market for its implications for the situation within the Korean market. We declined to change paragraph 9.45 in this regard.

9.17. With respect to paragraph 10.52, Korea noted that the figures for premium diluted soju should state that it is five percent of the soju market not the distilled beverages market. We have corrected the reference. Korea also noted that premium soju sales currently have slowed. We do not think this detracts from the conclusions. As complainants noted, sales of imports have also slowed in recent months due to the current financial crisis in Korea.³³¹ The higher priced products such as premium diluted soju and imports have fallen off and sales of lower priced products have increased. The parties did not present extensive arguments about the relationship of the sales of the products to events occurring during the recent financial crisis³³² and we did not refer to such a period extensively, but, if anything, the similar trends in sales of imports and premium diluted soju (as well as the differential movement of standard diluted soju) in the situation can be taken to support our Findings. We made clarifications to paragraph 10.52 to reflect these comments.

³²⁹ Korea referred to the US statements about nine Korean-style restaurants found in the vicinity of the US embassy. However, Korea describes these establishments as "a few *very expensive* Korean restaurants" and "these nine *expensive* restaurants". Korean Comments on the Interim Report at p. 1. (emphasis added)

³³⁰ We take note that Japan stated in the panel proceedings of *Japan – Taxes on Alcoholic Beverages II* that soju and shochu were essentially identical products. *Japan – Taxes on Alcoholic Beverages II, supra.*, at para. 4.178.

³³¹ See EC Answer to Questions, Question 1 from the Panel at 1-2, and accompanying chart.

³³² We note that the Nielsen study and the Trendscape survey were done in 1998.

9.18. In comments regarding paragraphs 10.93 and 10.94, Korea took exception to several statements regarding pricing information. Korea stated that "Korea cannot fathom how such huge price differences can lead to a competitive relationship". Our conclusion was that, overall, there was persuasive evidence of a directly competitive relationship in spite of the price differences. We recall our observation that absolute price ratios are not a good basis upon which to assess whether there is a directly competitive relationship between products. Information as to how consumers behave in the face of relative price changes is more persuasive.

9.19. Korea also stated that it strongly objects to the Panel's alleged approach of narrowing the price differences between the products and argues that the Panel "conveniently" mismatched products because some comparisons were made between imports and premium diluted soju rather than standard diluted soju. However, in the textual discussion of the price differences, the first sentence of the listing stated the price difference between premium diluted soju and standard diluted soju. There followed a listing of the price differences between some imports and premium diluted soju. We included a footnote with further price differences between imports and premium diluted soju and standard diluted soju. We do not understand what Korea apparently thought was concealed by these figures as all information was included. Nonetheless, we will amend the paragraph and footnote to calculate the remaining figures for purposes of clarity. We made the appropriate changes to paragraph 10.94.

9.20. Also with respect to paragraph 10.94, Korea objected to the Panel's alleged reliance on prices based on alcohol strength to support its conclusions. We made no such reliance. In mentioning price adjusted for alcohol strength in a footnote to the paragraph, we merely observed that this was the manner of the price comparisons used in the case of *Japan – Taxes on Alcoholic Beverages II* and noted that the absolute price ratio differences in the present case were more similar to those in that case than would otherwise appear from a casual reference to the appendices in that case. Or, alternatively, if the prices in the Japanese case were *not* adjusted for alcohol strength, the price ratios between the imported and domestic products in Japan are shown to be more similar to the price ratios of imported and domestic products in Korea than would otherwise appear to be the case. We further clarified the language in the paragraph and footnote to reflect this concern.

9.21. Korea disagreed with our treatment of distilled and diluted soju. They note that the Korean Fair Trade Commission ("KFTC") statement outlines one difference regarding distillation methods, but that there are others including differences in price. However, the KFTC did not simply state that the method of distillation was a difference; it stated that it was "the *basic* difference".³³³ After noting this we went on to discuss the other differences, including price. We declined to change paragraph 10.54 in this regard.

9.22. With respect to a footnote to paragraph 10.67, Korea argued that the Findings take their statements regarding differences in bottle sizes and types out of context. Korea states that it was emphasizing that the bottles used for exports of soju to Japan were different from shochu and that shochu bottles were meant to be similar to imports such as whisky. Presumably, Korea wished us to draw the conclusion that soju is marketed differently from shochu and whisky as a point of product distinction. This, in fact, was the issue we addressed. In any event, we clarified the specific reference to bottle size and shape differences made by Korea.

9.23. Korea requested the panel to amend the Findings in paragraphs 10.63 and 10.64 to "incorporate and consider" Korea's arguments in its Second Oral Statement on whether bottled and tap water are competitive products. We listened to Korea's statements in this regard and considered them. Lack of a specific citation to every single argument made by parties in the Findings does not in any manner imply that such arguments were not considered. We did not find the Korea analogy about tap

³³³ Emphasis added.

water and bottled water probative or useful. The analogy is incomplete and refers to different products in different countries and thus no useful inference could be drawn for the inquiry at hand. However, we have added Korea's requested statements to the descriptive portion of the Report but have declined to amend these paragraphs in this regard.

9.24. Korea argued with the statement in paragraph 10.78 that soju and shochu are traditional drinks in their respective countries. Korea argues that sake "is *the* traditional drink of Japan".³³⁴ We did not state that shochu is *the* traditional drink of Japan. We referred to it and soju as traditional drinks without further qualification. We do not agree that there is only one traditional drink per country. Various regions or groups within countries may have traditional drinks. We declined to alter this paragraph.

9.25. With respect to paragraph 10.79, Korea noted that references to colourings with respect to premium soju are inaccurate. With respect to mention of the photographic exhibits submitted by complainants, Korea objects to references to pictures of premium diluted soju. We do not agree with the objection; advertisements of premium soju are relevant. Korea also objected to use of advertisements aimed at the Japanese market. Paragraph 10.80 deals with much of the Korea disagreement. However, we take note of their point with respect to some of the photographs. For instance, Exhibit I should not be included in this specific footnote because it is a Japanese product. However, we again note the statement by Japan in *Japan – Taxes on Alcoholic Beverages II* that soju and shochu are essentially identical products.³³⁵ We also take note that Exhibit D is distilled soju rather than diluted soju. However, given our conclusions regarding distilled and diluted soju, no substantive difference results. The paragraph and footnote references were amended as appropriate.

9.26. Korea also objected to references in paragraphs 10.79 and 10.80 to Jinro's website advertisement because, according to Korea, all advertising is essentially local. We do not agree with this argument. As discussed in these and other paragraphs, we consider such evidence relevant. The question is one of evidentiary significance, i.e., how much weight should be given to such evidence. We declined to further amend these paragraphs in this regard.

³³⁴ Emphasis added.

³³⁵ *Japan – Taxes on Alcoholic Beverages II*, *supra.*, at para. 4.178.

X. FINDINGS

A. CLAIMS OF THE PARTIES

10.1. The European Communities and the United States claim that Korea applies its internal tax laws (the Liquor Tax Law and the Education Tax Law) on vodka in excess of taxes applied to soju and is therefore in breach of its obligations under Article III:2, first sentence, of GATT 1994. The complainants also argue that these internal tax laws are applied in a dissimilar manner to other imported distilled alcoholic beverages so as to afford protection to the domestic industry in breach of Korea's obligations under Article III:2, second sentence. The complainants have identified the imported products as all distilled alcoholic beverages described within Harmonized System classification 2208. They have identified specific examples of such beverages as including whiskies, brandies, cognac, liqueurs, vodka, gin, rum, tequila and "ad-mixtures". The complainants have identified soju as the domestically produced distilled alcoholic beverage which they claim receives preferential tax treatment.

10.2. Korea has responded that its internal tax measures are not inconsistent with its obligations under Article III:2. Korea argues that there are two types of soju, distilled and diluted, and that neither of these products are like the imported products and that the imports and the domestic products also are not directly competitive or substitutable. Korea argues that Article III:2 should be narrowly construed so as not to unduly infringe the sovereign right of Members of the WTO to structure their tax laws as they see fit. Korea claims that the complainants have not proved that with respect to the Korean market the products in question are either like or directly competitive or substitutable.

B. PRELIMINARY ISSUES

10.3. Korea raised the following preliminary issues and requested preliminary rulings with respect to:

- (i) the specificity of the panel requests of the complainants;
- (ii) the complainants' alleged non-compliance with certain provisions of the DSU relating to the conduct of consultations;
- (iii) alleged breaches of the confidentiality of the consultation process;
- (iv) alleged late submission of evidence; and
- (v) permission to have private counsel attend the Panel meetings and address the Panel.³³⁶

1. Specificity

10.4. Korea argues that the European Communities, in its request for a panel, has referred to a preferential tax rate on soju vis-a-vis certain alcoholic beverages falling within HS heading 2208.

³³⁶ The question of confidentiality of consultations was first identified in a footnote to Korea's First Submission and further explained by Korea at the first Panel meeting. The issues of specificity of the complaints and adequacy of the consultations were raised for the first time in Korea's Statement at the first Panel meeting. The complainants were given the opportunity to address the issues of confidentiality, specificity and adequacy of consultations in writing in their rebuttal briefs and we delivered our decision on these matters at the beginning of the second Panel meeting. The issue of the alleged late submission of evidence was raised by Korea following the second Panel meeting. We address the question here for the first time. The issue of private counsel was raised and addressed prior to the first meeting of the Panel.

Korea states that the European Communities has not, even in its written submission, clarified its position on the category of alcoholic beverages falling within the scope of this dispute.

10.5. Korea states that the US request for a panel lacks specificity as well. Korea notes that the United States, in its request for a panel, refers to higher tax rates on "other distilled spirits", while specifically mentioning "whisky, brandy, vodka, rum, gin, and ad mixtures".

10.6. Korea argues that such vaguely worded complaints violate its rights of defence. According to Korea, HS 2208 is a very broad tariff classification, which covers a wide variety of alcoholic beverages, including non-western liquors such as koryangu, Korean soju, Insam ju, Ogapiju, and Japanese shochu. More precisely, Korea argues that this lack of specificity of the complainants' claims is improper for two reasons:

- (i) it frustrates Korea's right of defense, which Korea argues is a general principle of due process implicit in the DSU;
- (ii) it violates what Korea considers a clear obligation of the DSU, which is that such a request should "identify" the specific measures at issue, and "present the problem clearly", as stipulated in Article 6.

Korea, therefore, requested the panel to issue a preliminary ruling, limiting the products at issue in this dispute.

10.7. Korea also submits that it is unable to identify which items the United States is referring to by its reference to 'ad-mixtures' in its request for a panel. Korea also claims that the complainants did not clearly distinguish the domestic liquors that are supposed to be more favourably taxed in Korea. Korea states, in particular, that the complainants have not distinguished between Korea's distilled soju, an artisanal product sold at very high prices in tiny quantities, and subject to a 50% tax rate, on the one hand, and, on the other hand, diluted or standard soju, which is an inexpensive drink, consumed in large quantities with meals and taxed at a rate of 35%. Korea argues that in their requests for a panel, both complainants have referred to only one 'soju' product, without acknowledging that there are, in reality, two different products, with two different tax rates.

10.8. The European Communities notes that its request for a panel refers to ".. certain alcoholic beverages falling within HS 22.08", but rejects Korea's assertion that it has, through its first submission, broadened the scope of its complaint as contained in the request for a panel. The European Communities submits that its first submission refers to "soju and all other distilled spirits and liqueurs falling within HS 22.08". In the EC view, these statements are consistent. According to the European Communities, its panel request is more than sufficiently specific to meet the minimum requirements of Article 6.2 of the DSU.

10.9. The United States argues that Article 6.2 of the DSU requires, inter alia, that the request for a panel "identify the specific measures at issue and provide a brief summary of the legal basis of the complaint sufficient to present the problem clearly." According to the United States, its panel request satisfies both these requirements, and it also clearly includes all distilled spirits within HS heading 2208, as maintained in the first US submission. The United States argues that in accordance with Article 6.2, its request for the establishment of a panel defined the Korean measures at issue: the general Liquor Tax Law and the Education Tax; and provided a brief summary of the legal basis of the complaint.

10.10. The United States refers to *European Communities - Regime for the Importation, Sale and Distribution of Bananas (Bananas III)*, where the Appellate Body, according to the United States, noted that this provision concerning the legal basis requires that the request for a panel must be

sufficiently specific with respect to the claims being advanced, but need not lay out all the arguments that will subsequently be made in the party's submission.³³⁷ The United States argues that Korea's request that the Panel limit the proceeding to five specific products (whisky, brandy, vodka, rum, and gin) is equally without basis in Article 6.2. According to the United States, the panel request, which defines the terms of reference of the panel, refers to taxation of "other distilled spirits" -- i.e., distilled spirits other than soju. By using the term "such as," the United States claims that it sets forth the five products and "ad mixtures" as examples, and not as an exclusive list. According to the United States, the extent to which the United States and the European Communities establish that all such products are "like" or "directly competitive or substitutable" is a matter to be determined through the course of these proceedings, beginning with the first written submission to the Panel.

10.11. As regards the question of defining which soju is referred to, the European Communities states that it regards all the varieties of soju as one product, with the necessary result that 'liqueurs' are more heavily taxed than some soju. According to the European Communities, the question of whether soju is or is not a single product is a substantive issue which cannot be decided by the panel in a preliminary ruling. The United States also argues that with respect to the use of the word "soju," its panel request makes it clear that the tax preference for all soju is covered, giving Korea ample objective notice that the entire category was to be challenged.

10.12. We note that Article 6.2 of the DSU provides in the relevant part that:

The request for the establishment of a panel shall be made in writing. It shall indicate whether consultations were held, identify the specific measures at issue and provide a summary of the legal basis of the complaint sufficient to present the problem clearly.

10.13. The Appellate Body noted in *Bananas III* that:

As a panel request is normally not subjected to detailed scrutiny by the DSB, it is incumbent upon a panel to examine the request for the establishment of the panel very carefully to ensure its compliance with both the letter and spirit of Article 6.2.³³⁸

10.14. The question of whether a panel request satisfies the requirements of Article 6.2 is to be determined on a case by case basis with due regard to the wording of Article 6.2. The question for determination before us, therefore, is whether the phrases used by the EC ("certain alcoholic beverages falling within HS heading 2208") and the United States ("other distilled spirits such as whisky, brandy, vodka, gin and ad-mixtures") are specific enough to satisfy the letter and spirit of Article 6.2. In other words, the question is whether Korea is put on sufficient notice as to the parameters of the case it is defending. As the Appellate Body noted in *Bananas III*:

It is important that a panel request be sufficiently precise for two reasons: first, it often forms the basis for the terms of reference of the panel pursuant to Article 7 of the DSU; and, second, it informs the defending party and the third parties of the legal basis of the complaint.³³⁹

10.15. Korea argues that each imported product must be specifically identified in order to be within the scope of the panel proceeding. The complainants argue that the appropriate imported product is all distilled beverages. They claim, in fact, that for purposes of Article III, there is only one category

³³⁷Appellate Body Report on *European Communities – Regime for the Importation, Sale and Distribution of Bananas (Bananas III)*, adopted on 25 September 1997, WT/DS27/AB/R, at para. 141.

³³⁸*Ibid.*, at para. 142.

³³⁹*Ibid.*, para. 142.

in issue. They claim to have identified specific examples of such distilled alcoholic beverages for purposes of illustration, not as limits to the category.

10.16. The issue of the appropriate categories of products to compare is important to this case. In our view, however, it is one that requires a weighing of evidence. As such it is not an issue appropriate for a preliminary ruling in this case. This is particularly so in light of the Appellate Body's opinion in *Japan - Taxes on Alcoholic Beverages II*,³⁴⁰ that all imported distilled alcoholic beverages were discriminated against. That element of the decision is not controlling on the ultimate resolution of other cases involving other facts; however, it cannot be considered inappropriate for complainants to follow it in framing their request for a panel in a dispute involving distilled alcoholic beverages. While it is possible that in some cases, the complaint could be considered so vague and broad that a respondent would not have adequate notice of the actual nature of the alleged discrimination, it is difficult to argue that such notice was not provided here in light of the identified tariff heading and the Appellate Body decision in the *Japan - Taxes on Alcoholic Beverages II*. Furthermore, we note that the Appellate Body recently found that a panel request based on a broader grouping of products was sufficiently specific for purposes of Article 6.2.³⁴¹ We find therefore, that the complainants' requests for a panel satisfied the requirements of Article 6.2 of the DSU.

2. Adequacy of consultations

10.17. Korea submits that what it considers to be explicit obligations contained in Articles 3.3, 3.7 and 4.5 of the DSU have been violated. Korea in effect alleges that the complainants did not engage in consultations in good faith with a view to reaching a mutual solution as envisaged by the DSU. According to Korea, there was no meaningful exchange of facts because the complainants treated the consultations as a one-sided question and answer session, and therefore, frustrated any reasonable chance for a settlement. Korea considers this non-observance of specific provisions of the DSU as a "violation of the tenets of the WTO dispute settlement system" and requests the Panel for a ruling .

10.18. Both complainants assert that Korea's claim would appear to be that they have infringed Articles 3.3, 3.7 and 4.5 of the DSU because they did not attempt to reach a mutually acceptable solution to the dispute in the course of the consultations that preceded the establishment of this Panel. The complainants refer to the panel decision in *Bananas III* for the proposition that the conduct of consultations is not the concern of a panel but that the panel need only concern itself with the question whether consultations did in fact take place,³⁴² and point out that Korea cannot dispute the fact that consultations were in fact held on three separate occasions between itself and both the United States and the EC. The complainants state that, in any event it is not true that they refused to engage in a 'meaningful exchange of facts' during the GATT Article XXII consultations. They allege that it was Korea's attitude during the consultations which prevented such exchange from taking place.

10.19. In our view, the WTO jurisprudence so far has not recognized any concept of "adequacy" of consultations. The only requirement under the DSU is that consultations were in fact held, or were at least requested, and that a period of sixty days has elapsed from the time consultations were requested to the time a request for a panel was made. What takes place in those consultations is not the concern of a panel. The point was put clearly by the Panel in *Bananas III*, where it was stated:

Consultations are . . . a matter reserved for the parties. The DSB is not involved; no panel is involved; and the consultations are held in the absence of the Secretariat.

³⁴⁰ Appellate Body Report on *Japan - Taxes on Alcoholic Beverages (Japan - Taxes on Alcoholic Beverages II)*, adopted on 1 November 1996, WT/DS8/AB/R, WT/DS10/AB/R, WT/DS11/AB/R, at pp. 26, 32.

³⁴¹ Appellate Body Report on *European Communities – Customs Classification of Certain Computer Equipment*, adopted on 22 June 1998, (WT/DS62/AB/R, WT/DS67/AB/R), at paras. 58-73.

³⁴² Panel Report on *Bananas III*, *supra* at paras. 7.18-7.19.

While a mutually agreed solution is to be preferred, in some cases it is not possible for parties to agree upon one. In those cases, it is our view that the function of a panel is only to ascertain that the consultations, if required, were in fact held. ...³⁴³

We do not wish to imply that we consider consultations unimportant. Quite the contrary, consultations are a critical and integral part of the DSU. But, we have no mandate to investigate the adequacy of the consultation process that took place between the parties and we decline to do so in the present case.

3. Confidentiality

10.20. Korea alleges that both complainants have breached the confidentiality requirement of Article 4.6 of the DSU by making reference, in their submissions, to information supplied by Korea during consultations.

10.21. The European Communities argues that Korea's interpretation of Article 4.6 of the DSU is wrong. According to the European Communities, the confidentiality requirement of Article 4.6 of the DSU concerns parties not involved in the dispute and the public in general. The European Communities stresses that the requirement cannot in any way be read as referring to the panel itself. In the EC view, Article 4.6 cannot be interpreted as a limitation on the rights of parties at the panel stage.

10.22. The United States argues that to the extent Korea is alleging a violation of the DSU, such a claim is not within the terms of reference of the Panel. The United States further argues that Korea's complaints about the alleged inadequacy of the complainants' attempts to settle the dispute or engage in good faith consultations have no bearing on the authority of the Panel or the progress of this proceeding.

10.23. We note that Article 4.6 of the DSU requires confidentiality in the consultations between parties to a dispute. This is essential if the parties are to be free to engage in meaningful consultations. However, it is our view that this confidentiality extends only as far as requiring the parties to the consultations not to disclose any information obtained in the consultations to any parties that were not involved in those consultations. We are mindful of the fact that the panel proceedings between the parties remain confidential, and parties do not thereby breach any confidentiality by disclosing in those proceedings information acquired during the consultations. Indeed, in our view, the very essence of consultations is to enable the parties gather correct and relevant information, for purposes of assisting them in arriving at a mutually agreed solution, or failing which, to assist them in presenting accurate information to the panel. It would seriously hamper the dispute settlement process if the information acquired during consultations could not subsequently be used by any party in the ensuing proceedings. We find therefore, that there has been no breach of confidentiality by the complainants in this case in respect of information that they became aware of during the consultations with Korea on this matter.

4. Late submission of evidence

10.24. Korea complains that its rights of defense were violated by the late submission of a market study (the Trendscape survey) by the European Communities. Korea had submitted a study done by the AC Nielsen Company as part of its responses to questions arising from the first substantive meeting of the Panel. The European Communities responded to this with, among other things, the Trendscape survey presented at the Second Meeting of the Panel. The Panel gave Korea a week to respond to this and critique the results, methodology and questions used in the Trendscape survey.

³⁴³Ibid., para. 7.19. The issue was not appealed.

Korea argues that this time was insufficient, that it did not have copies in Korean of all the questions - asked, and that it did not have time to provide further questions or comments based upon the answers.

10.25. We do not consider that Korea's rights under the DSU were violated. The European Communities submitted its rebuttal survey at the next available opportunity after receiving Korea's Nielsen survey. Had Korea chosen to submit its survey at the first substantive meeting and the European Communities failed to respond at the next opportunity (in such a case, it would have been in the rebuttal submission), there obviously would have been more merit to the claim because then the European Communities, it could have been argued, delayed submitting their evidence. As it transpired, the European Communities submitted a new piece of evidence at the next available opportunity which Korea then was able to examine for a week in order to provide comments. The survey was not of a particularly complex type and, in our view, Korea had adequate time to respond given the nature of the evidence. The Trendscope survey is not critical evidence to the complainants' case; it serves as a supplement to arguments already made. If we considered that it represented critical evidence, Korea's request for further time for comment would have been given greater weight. While all parties to litigation might prefer open-ended potential for rebutting the other side's submissions, we believe that for practical reasons submissions must be cut-off at some point and such a point was reached in this case. Thus, neither the timing nor the importance of the evidence in question support a finding that Korea's rights have been violated in this instance.

5. Private counsel

10.26. Korea indicated at the outset of the panel process that it wished to have the right to private counsel at the substantive meetings of the Panel. In Korea's view, in order to fully defend its interests and match the much greater resources of the complaining parties, Korea decided to retain the services of expert counsel with long standing experience in matters of international economic law and international economics.

10.27. Korea refers to the recent opinion of the Appellate Body in *Bananas III*, in which the Appellate Body stated that it found nothing in the WTO Agreement, the DSU, its Working Procedures, in customary international law or the prevailing practice of international tribunals, which prevented a Member from determining its delegation to the Appellate Body's proceedings.³⁴⁴ Korea adds that the Appellate Body also noted that representation by counsel of a government's own choice in proceedings before it (the Appellate Body) might well be a matter of particular significance to enable WTO Members to participate fully in WTO dispute settlement proceedings. According to Korea, the same holds true with respect to delegations presenting a case before a Panel. Korea further submits that under customary international law, it has the sovereign right to determine the composition of its delegation to panel hearings.³⁴⁵ Korea also believes its right to counsel of its choice is consistent with what it considers to be basic due process principles implicit in the DSU. Korea indicated that it appreciated that the Panel might have concerns about the confidentiality of the proceedings. Korea assured the Panel that it would ensure that any member of its delegation, including private counsel, will fully respect the confidentiality of the proceedings in accordance with applicable rules.

10.28. The European Communities indicates that it has no objection, in principle, to the presence of private counsel as part of Korea's delegation during substantive meetings of the Panel. The European Communities states, however, that they attach great importance to the preservation of confidentiality of panel proceedings. The EC acceptance was, therefore, made conditional upon Korea assuming full responsibility for any breach of confidentiality which may result from the presence at the Panel

³⁴⁴ Appellate Body Report, *supra.*, p. 8.

³⁴⁵ Korea refers to *Korea - Restrictions on Imports of Beef*, adopted on 7 November 1989, BISD 36S/202.

meetings of non-governmental persons. The European Communities take regard of the assurances given by Korea to the effect that its private counsel, like any other member of its delegation, would fully respect the confidentiality of the proceedings.

10.29. The United States notes that the Members of the WTO have agreed to abide by the rules and procedures in the DSU. They have agreed that dispute practice in the WTO will be guided by, and will adhere to, the established practice applied in disputes under the GATT 1947 system. According to the United States, this practice has excluded the routine presence of private lawyers in panel proceedings. The United States asserts that the GATT and WTO practice reflects the dual nature of the dispute settlement rules in the DSU; namely, reaching mutually agreeable solutions and adjudicating disputes. In the view of the United States, a decision by this panel to permit participation of private lawyers in panel meetings is not a trivial step. The effectiveness of WTO dispute settlement is a major accomplishment of the WTO as an international organization. The balance of elements that created this success has evolved by experience over considerable time. It is also the US view that if the Panel wishes to permit private lawyers or non-lawyer advisors to be in this proceeding, the Panel should consider this decision with great care, and impose appropriate safeguards with respect to the conduct of such persons.

10.30. The United States further argues that Panel must require effective safeguards that ensure that private counsel will not leak confidential business information or other privileged information generated during the panel process, and that if they do, there will be meaningful consequences. According to the United States, there is no excuse for damaging the interests of private parties by leaks of confidential business information; such leaks will in turn damage the reputation of WTO dispute settlement among trading businesses who are the strongest supporters of open trade.

10.31. Having considered the request of Korea for the right to use private counsel at the panel meetings, and the responses the European Communities and the United States, we decided to permit the appearance of private counsel before the Panel and to allow them to address arguments to the Panel in this case. In our view, it is appropriate to grant such a request in order to ensure that Korea has every opportunity to fully defend its interests in this case. However, such permission is granted based on the representations by Korea that the private counsel concerned are official members of the delegation of Korea, that they are retained by and responsible to the Government of Korea, and that they will fully respect the confidentiality of the proceedings and that Korea assumes full responsibility for confidentiality of the proceedings on behalf of all members of its delegation, including non-government employees.

10.32. We note that written submissions of the parties which contain confidential information may, in some cases, be provided to non-government advisors who are not members of an official delegation at a panel meeting. The duty of confidentiality extends to all governments that are parties to a dispute and to all such advisors regardless of whether they are designated as members of delegations and appear at a panel meeting.

10.33. The United States offered several suggestions for new rules and procedures in regard to these questions. However, in our view, the broader question of establishing further rules on confidentiality and possibly rules of conduct specifically directed at the role of non-governmental advisors generally is a matter more appropriate for consideration by the Dispute Settlement Body and is not within the terms of reference of this Panel.

C. MAIN ISSUES

1. Interpretation of Article III:2

10.34. Article III:2 provides two standards for examining complaints about a Member's internal taxation laws. The first sentence of Article III:2 provides:

The products of the territory of any Member imported into the territory of any other Member shall not be subject, directly or indirectly, to internal taxes or other internal charges of any kind in excess of those applied, directly or indirectly, to like domestic products.

The second sentence provides:

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

Paragraph 1 of Article III provides:

The 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.

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.³⁴⁶

10.35. 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 taxation³⁴⁷ and whether the taxation differences are applied so as to afford protection to the domestic industry.

10.36. The general approach in past Article III:2 cases has been to examine first whether any of the products at issue are "like." However, previous cases have found that the category of like products is

³⁴⁶ *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 II*, *supra*, at p. 24.

³⁴⁷ 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."

a subset of those products which are directly competitive or substitutable.³⁴⁸ It therefore seems more logical to us to approach the issue by examining the broader category first.

10.37. Before beginning to analyze the evidence presented, we must first decide how the term "directly competitive or substitutable" should be interpreted. Article 31 of the Vienna Convention summarizes the international law rules for the interpretation of treaty language. It provides in paragraph 1 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. According to paragraph 2, the context includes the full text, the preamble, the annexes and any mutually agreed interpretive language. Paragraph 3 provides that account shall also be taken of any subsequent practice or interpretations as well as relevant rules of international law.

10.38. The Appellate Body in *Japan – Taxes on Alcoholic Beverages II* stated that "like product" should be narrowly construed for purposes of Article III:2. It then noted that directly competitive or substitutable is a broader category, saying: "How much broader that category of 'directly competitive or substitutable products' may be in a given case is a matter for the panel to determine based on all the relevant facts in that case."³⁴⁹ 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.³⁵⁰ Other examples provided were domestic linseed oil and imported tung oil³⁵¹ and domestic synthetic rubber and imported natural rubber.³⁵² 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.³⁵³

10.39. This negotiating history illustrates the key question in this regard. It is whether the products are **directly** competitive or substitutable. Tramways and busses, when they are not directly competitive, may still be indirectly competitive as transportation systems. Similarly even if most power generation systems are set up to utilize either coal or fuel oil, but not both, these two products could still compete indirectly as fuels.³⁵⁴ Thus, the focus should not be exclusively on the quantitative extent of the competitive overlap, but on the methodological basis on which a panel should assess the competitive relationship.

10.40. At some level all products or services are at least indirectly competitive. Because consumers have limited amounts of disposable income, they may have to arbitrate between various needs such as giving up going on a vacation to buy a car or abstaining from eating in restaurants to buy new shoes or a television set. However, an assessment of whether there is a direct competitive relationship

³⁴⁸ Panel Report on *Japan -- Taxes on Alcoholic Beverages II*, *supra.*, at para. 6.22. This finding was not modified or reversed by the Appellate Body. See, Appellate Body Report, *supra.*, at p. 23.

³⁴⁹ Appellate Body Report on *Japan -- Taxes on Alcoholic Beverages II*, *supra.*, at p. 25.

³⁵⁰ EPCT/A/PV/9, at p. 7.

³⁵¹ E/Conf.2/C.3/SR.11,p.1 and Corr. 2.

³⁵² *Ibid.* at p. 3.

³⁵³ E/Conf.2/C.3/SR.40 at p. 2.

³⁵⁴ To follow on from these hypotheticals, it can be noted that some large power generation facilities may be convertible from coal to fuel oil or a series of power stations in a particular market could be set for replacement and alternative fuel sources might be under consideration. In such instances there may be direct competition. Hence the statements of the delegates that a review of the specific market structure is necessary to determine the nature of the competition.

between two products or groups of products requires evidence that consumers consider or could consider the two products or groups of products as alternative ways of satisfying a particular need or taste.

10.41. The Panel in *Japan – Taxes on Alcoholic Beverages II* noted that the 1989 Japanese tax reform had eliminated the distinctions between various grades of whisky. The result was that domestic whisky production declined relatively. Its market share fell and both shochu and foreign-produced whisky's market share rose. The Panel stated:

In the Panel's view, the fact that foreign produced whisky and shochu were competing for the same market share [held by domestic whisky] is evidence that there was elasticity of substitution between them.³⁵⁵

Imported whisky and shochu may each have been competing independently with domestic whisky. We would agree with that panel that showing such indirect competition may provide evidentiary support for a finding of direct competitiveness. However, such a showing is insufficient on its own. To use a hypothetical case for illustration, it is possible that in some markets distilled beverages could be shown to compete with wine; beer could also be shown to compete with wine. However, such evidence does not reveal whether the relationship is direct or indirect. More would need to be shown in such a case to establish that distilled beverages and beer are *directly* competitive or substitutable with respect to each other in that market.

10.42. In our view, it is also the case that quantitative analyses, while helpful, should not be considered necessary. In examining the Korean market, a determination of the precise extent of the competitive overlap is complicated by the fact that, as the 1987 and 1996 panels noted in the *Japan – Taxes on Alcoholic Beverages I and II*, the intervention of government policies can cause distortions, including understatement, of the quantitative extent of the competitive relationship. Indeed, there must be some concern that a focus on the quantitative extent of competition instead of the nature of it, could result in a type of trade effects test being written into Article III cases. That is, if a certain *degree* of competition must be shown, it is similar to showing that a certain *amount* of damage was done to that competitive relationship by the tax policies in question. The Appellate Body stated:

Moreover, it is irrelevant that the "trade effects" of the tax differential between imported and domestic products, as reflected in the volumes of imports, are insignificant or even non-existent, Article III protects expectations not of any particular trade volume but rather of the equal competitive relationship between imported and domestic products.³⁵⁶

10.43. The question for us to decide is whether in Korea the domestic and imported products are directly competitive or substitutable. This requires evidence of the direct competitive relationship between the products, including, in this case, comparisons of their physical characteristics, end-uses, channels of distribution and prices.³⁵⁷

³⁵⁵ Panel Report on *Japan -- Taxes on Alcoholic Beverages II*, *supra.*, at para. 6.30.

³⁵⁶ Appellate Body Report on *Japan -- Taxes on Alcoholic Beverages II*, *supra.*, at p. 16. Obviously, the expectation of competitive conditions must be a reasonable one.

³⁵⁷ These are the categories of evidence we have examined in this case to determine whether the products in question are directly competitive or substitutable. Obviously, the availability and probative value of categories of evidence may differ from case to case.

2. Evidentiary issues

(i) *Cross-price elasticity*

10.44. The Appellate Body approved the panel's decision in *Japan – Taxes on Alcoholic Beverages II* to look not only at products' physical characteristics, common end-uses, and tariff classifications, but also at the market place. It approved the examination of the economic concept of "substitution" as one means of examining the relevant markets. The use of cross-price elasticity of demand was approved but it was specifically noted that it is not the decisive criterion.³⁵⁸ While a high degree of cross-price elasticity of demand would tend to support the argument that there is a direct competitive relationship, it is only one evidentiary factor. If there is a high quantitative level of competition between products, it is likely that the qualitative nature of the competition is direct. However, the lack of such evidence may be due to the governmental measures in question. As noted, both panels in *Japan – Taxes on Alcoholic Beverages I and II* made the observation that government policies can influence consumer preferences to the benefit of the domestic industry. It was stated that:

a tax system that discriminates against imports has the consequence of creating and even freezing preferences for consumer 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.³⁵⁹

This is particularly a problem if the products involved are consumer items that are so-called experience goods which means that consumers tend to purchase what is familiar to them and experiment only reluctantly. This issue will be discussed further below. Thus the 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.

(ii) *Evidence from outside the Korean market*

10.45. Other elements of evidence besides cross-price elasticity are relevant to the analysis. In our view, another element of relevant evidence is the nature of competition in other countries. We are mindful of the admonition of the Appellate Body in the case of *Japan -- Taxes on Alcoholic Beverages II*, that these disputes must be evaluated on a case-by-case basis taking into account the conditions in the market in question. However, as we are looking at the nature of competition in a market that previously was relatively closed and still has substantial tax differentials, such evidence of competitive relationships in other markets is relevant. Similarly, we consider it relevant as to how Korean manufacturers of soju are marketing their beverages outside Korea. According to Korea, the panel should strictly limit its view to what happens in the Korean market place. Nothing that happens outside Korea can be considered relevant in determining whether the products in question are directly competitive or substitutable within Korea. Also, Korean manufacturer's export marketing efforts are to be given no weight. In our view, this is an overly restrictive approach and does not accord with market realities. It is true that the question to be answered concerns the Korean market, but that in no way implies that what happens in regard to the same products outside of the Korean market is irrelevant to assessing the actual and potential market conditions within Korea.

³⁵⁸ Appellate Body Report on *Japan -- Taxes on Alcoholic Beverages II*, *supra.*, at p. 25.

³⁵⁹ Panel Report on *Japan – Taxes on Alcoholic Beverages II*, *supra.*, at para. 6.28, citing, Panel Report on *Japan - Customs Duties, Taxes and Labelling Practices on Imported Wines and Alcoholic Beverages*, adopted on 10 November 1987, BISD 34S/83, at para. 5.9.

10.46. In some cases, the only market evidence available may be with respect to non-domestic markets due to the tax, duty and regulatory structure in the country in question. Sometimes, the only reasonable manner of assessing what the market situation would be absent such policy structures is to look at other markets and make a judgement as to whether the same patterns could prevail in the case at hand. However, we do not need to decide such a stark issue in this case; there is considerable evidence available as to what is taking place within the Korean market. We do not need, in this case, to give substantial weight to conditions in markets outside Korea, but such factors are relevant and should be taken into consideration in determining the nature of the competitive relationships involved here.³⁶⁰ As noted above, the panels stated in *Japan – Taxes on Alcoholic Beverages I and II* that systems of government tax policies may have the effect of freezing consumer preferences in place in favour of the domestic product. To completely ignore such evidence from other markets would require complete reliance on current market information which may be unreliable, due to its tendency to understate the competitive relationship, because of the very actions being challenged. Indeed, the result could be that the most restrictive and discriminatory government policies would be safe from challenge under Article III due to the lack of domestic market data.

(iii) *Potential competition*

10.47. Another question that has arisen is the temporal nature of the assessment of competition. All parties agree that the Panel should look at both actual and potential competition. However, Korea argues that potential competition does not include future competition. They argue that at most, the Panel must make a "but for" decision. That is, but for the taxes would the products be directly competitive or substitutable at the present moment. Korea further argues that if the market changes, then the complainants are within their rights to raise the matter again at some time in the future.

10.48. Korea's arguments in this regard are not persuasive. We, indeed, are not in the business of speculating on future behaviour. However, we do not agree that any assessment of potential competition with a temporal aspect is speculation. It depends on the evidence in a particular case. Panels should look at evidence of trends and changes in consumption patterns and make an assessment as to whether such trends and patterns lead to the conclusion that the products in question are either directly competitive now or can reasonably be expected to become directly competitive in the near future. It is not evident why such an assessment is any more speculative in nature than the "but for" analysis itself. Such an analysis also requires making an assessment about what would happen in the theoretical case of the tax differentials being removed. In our view, the approach suggested by Korea is too static. It would be a profoundly troubling development in GATT/WTO jurisprudence if Members were forced to return to dispute settlement on the same laws over and over only because the market in question had not yet changed enough to justify a finding at a particular moment. Such an interpretation would be contrary to the settled law that competitive expectations and opportunities are protected.³⁶¹ As noted above, the Appellate Body in *Japan -- Taxes on Alcoholic Beverages II* stated:

Article III protects **expectations** not of any particular trade volume but rather of the equal competitive relationship between imported and domestic products.³⁶²

According to the 1949 *Working Party Report on Brazil Internal Taxes*:

³⁶⁰ See, Appellate Body Report on *European Communities – Customs Classification of Certain Computer Equipment*, *supra.*, at para. 93.

³⁶¹ We also note that a requirement of substantial current market presence would be a particularly high hurdle for less wealthy exporters.

³⁶² Appellate Body Report in *Japan Alcoholic Beverages II*, *supra.*, at p. 16 (emphasis added).

[The majority of the working party] argued that the absence of imports from contracting parties during any period of time that might be selected for examination would not necessarily be an indication that they had no interest in exports of the product in affected by the tax, since their **potentialities** as exporters, given national treatment, should be taken into account.³⁶³

10.49. Similarly, the panel in the 1987 case of United States -- Taxes on Petroleum and Certain Imported Substances stated:

For these reasons Article III:2, first sentence, cannot be interpreted to protect expectations on export volumes; it protects **expectations** on the competitive relationship between imported and domestic products.³⁶⁴

The Shorter Oxford English Dictionary defines "potential" as follows:

potential 1. possible as opposed to actual; capable of coming into being; latent.³⁶⁵

The same dictionary defines "expectation" as follows:

expectation 1. The action of waiting for someone or something. . . .4. A thing expected or looked forward to.³⁶⁶

10.50. The interpretation proposed by Korea is not consistent with the standard meaning of the terms in question both of which clearly have a temporal element to their definitions. We will not attempt to speculate on what could happen in the distant future, but we will consider evidence pertaining to what could reasonably be expected to occur in the near term based on the evidence presented. How much weight to be accorded such evidence must be decided on a case-by-case basis in light of the market structure and other factors including the quality of the evidence and the extent of the inference required. To try to limit the inquiry as to what might happen this instant were the tax laws changed would involve us in making arbitrary distinctions between expectations now and those in the near future. Obviously, evidence as to what would happen now is more probative in nature than what would happen in the future, but most evidence cannot be so conveniently parsed. If one is dealing with products that are experience based consumer items, then trends are particularly important and it would be unrealistic and, indeed, analytically unhelpful to attempt to separate every piece of evidence and disregard that which discusses implications for market structure in the near future.

3. Products at issue

10.51. In order to determine whether the imported and domestic products are directly competitive or substitutable, it is necessary to properly identify such products. With respect to the domestic product, soju, there are two primary categories identified. There is distilled soju and diluted soju. Distilled soju has been described as soju made from a mix of additives and water blended into an alcohol

³⁶³*Brazilian Internal Taxes*, BISD II/181 at p. 185, para. 16 (emphasis added).

³⁶⁴*United States -- Taxes on Petroleum and Certain Imported Substances*, BISD 34S/136, at p. 158, para. 5.1.9 (emphasis added). We do not consider it a meaningful distinction on this issue that this quote refers to the first sentence of Article III:2 rather than the second sentence. To find otherwise would be to imply that one could refer to expectations with respect to determining the market conditions for examining like products but not for examining whether products are directly competitive or substitutable. Given that like products are a subset of directly competitive or substitutable products, this would be illogical.

³⁶⁵L. Brown (ed), *The New Shorter Oxford English Dictionary* (Clarendon Press, 1993), Vol. 2 at p. 2310 (emphasis in the original).

³⁶⁶*Ibid.* Vol. 1 at p. 885 (emphasis in original).

solution extracted by a method of single-step distillation.³⁶⁷ It is identified separately in the Korean tax law, although not in Korea's WTO Schedule of tariff bindings. Distilled soju accounts for less than one percent of soju sales in Korea. Distilled soju is taxed at a higher rate than diluted soju.

10.52. The other type of soju is what we have described as diluted soju. There was considerable discussion about the proper appellation for this product. The complainants described it as diluted soju and Korea maintained that it should be referred to as standard soju. We have adopted the name diluted soju for the product for purposes of descriptive clarity only, without any intention of thereby drawing substantive conclusions from the name. Within this category there is standard diluted soju and premium diluted soju.³⁶⁸ Standard diluted soju is a lower priced product that has been dominant since the 1960's. Premium diluted soju, which generally has additives for flavouring, has been introduced in the past few years. It is higher priced and the advertising for it has cultivated a more "up-market" image. Its market share has grown rapidly and it now represents approximately five percent of soju sales.³⁶⁹ All parties have agreed that premium and standard diluted soju are variations of one product. Diluted soju is described as:

soju made from a mix of additives, water and grain solution (or distilled soju solution -- the *Liquor Tax Act* classifies soju as being '*diluted*' soju where the ratio of the grain solution or the distilled soju solution amounts to 20% or less of the total volume of alcohol), blended into an alcohol solution extracted by a method of "continuous distillation".³⁷⁰

10.53. Korea has argued that distilled soju and diluted soju are two separate product categories for purposes of analysis under both sentences of Article III:2. Korea argues that the complainants must prove the imported products are like or directly competitive with or substitutable for each of the two domestic products separately and provide a comparison with each on a product-by-product basis. Complainants, on the other hand, argue that the two types of soju are nearly identical and therefore all soju is a single product for purposes of analysis in this case.

10.54. The distinction between distilled and diluted soju is more relevant to a discussion of like products where the product categories are narrower. The Korean Fair Trade Commission has stated that:

the basic difference between those two types of soju is whether the alcohol was extracted by means of single-step distillation or continuous distillation.³⁷¹

We are not convinced that this difference is significant. Moreover, in our view, to the extent there are differences between the two types of soju, distilled soju is more similar to the imported products than diluted soju. Distilled soju is higher priced than diluted soju; distilled soju (40-45 percent) has a higher alcohol content than diluted soju (20-25 percent); distilled soju often is used as gifts, an end-

³⁶⁷ See Korea First Submission, Attachment 1, Decision of the Fair Trade Commission of the Republic of Korea Case No. 9607, Advertisement 1023, 30 November 1996, at 3.

³⁶⁸ See discussion at footnote 20, above. To have decided otherwise would have left us discussing "standard soju" and "premium standard soju", terminology which would have been confusing.

³⁶⁹ The EC argues that it might account for as much as 10 percent of the market. Apparently, it is difficult to judge the market share precisely because there is no legal definition which would assist in compiling statistics. See para.6.24. Korea states that sales of premium diluted soju have declined recently. We also note that sales of imports have declined at the same time due, presumably, to the current financial crisis in Korea. The lower priced product, standard diluted soju has increased sales. These changes in levels of sales, if anything, can be taken as further support for the relationship of the products. See EC Answers to Questions, Question 1 from the Panel at pp. 1-2, and accompanying chart.

³⁷⁰ Korea First Submission, Attachment 1, *supra.*, at 3.

³⁷¹ *Ibid.*

use identified by Korea as one also pertaining to imports; distilled soju is aged as is the case with many of the imports. As is discussed further below, we do not think that these types of differences are sufficiently important to meaningfully distinguish between two products. We will proceed with an examination primarily of the competitive relationship of the imported products with diluted soju, including both standard and premium subcategories of diluted soju. If we find that diluted soju is directly competitive with and substitutable for the imported products, it will follow that this is also the case for distilled soju because distilled soju is intermediary between the imported products and diluted soju. Indeed, distilled soju is, on the one hand, more similar to the imported products than diluted soju and is, on the other hand, more similar to diluted soju than are the imported products.

10.55. With respect to the imported products, there is a fundamental and important disagreement between the parties to the dispute. Complainants argue that all distilled beverages are directly competitive or substitutable with each other. They have presented evidence with respect to several categories of such imported products, but not all products within the tariff heading 2208 which constitutes the parameters of the terms of reference. They have argued that they have presented evidence with respect to the primary imported products as examples of the broader category. The EC, in particular, argued that to present information on each and every type of distilled beverage would put too much of a burden on complainants and would overwhelm the Panel with details of little substantive importance. Both complainants have argued that the Appellate Body ruled that all imported distilled beverages were directly competitive with or substitutable for shochu in the case of *Japan -- Taxes on Alcoholic Beverages II*. They argue that we should take guidance from the Appellate Body's decision in that case.

10.56. The *Japan – Taxes on Alcoholic Beverages II* case provides unclear guidance for the present case. The panel in that instance made findings with respect to the western-style alcoholic beverages for which specific evidence was provided. However, the panel did not explicitly state that it was not making a determination with respect to the other products within HS 2208. The Appellate Body ruled that, as a matter of law, the panel erred in not making determinations with respect to all of the products within the terms of reference. The Appellate Body went on to find that all imported products identified by HS 2208 were directly competitive with or substitutable for the domestic product, shochu. In that case, the Appellate Body did not further explain its reasoning. We are unaware of the specifics of the *Japan – Taxes on Alcoholic Beverages II* case in this regard. While taking note of the Appellate Body's finding on this issue, we also recall the Appellate Body's statement that findings with respect to Article III:2 are to be made on a case-by-case basis.

10.57. In the present case, we are of the view that we cannot make affirmative findings with respect to products for which the complainants have provided virtually no evidence with respect to their physical characteristics, end-uses, retail outlets or prices.³⁷² It may be possible that the products identified by the complainants serve as adequate representatives of a broader category, but complainants did not provide such evidence and relied instead on assertions combined with reference to the prior Appellate Body decision regarding Japan. While, as stated, we will make reference to other markets when such markets provide relevant evidence to the determination, the evidence from the Japanese market and the determination of the Appellate Body in that case serves as an inadequate evidentiary basis for us to conclude that all products within HS 2208 are the appropriate category of imported products in the case of Korea. Indeed, to make the determination as requested by the complainants without further evidence could be to, in some circumstances, prejudge the case. If we were to follow their reasoning that the Appellate Body decision in *Japan – Taxes on Alcoholic Beverages II* case had determined the parameters of the imports for all cases, then because soju is

³⁷² The general statements by the United States and the European Communities regarding the use of the four digit tariff heading and the identified common physical characteristics and end-uses of distilled alcoholic beverages provides very weak evidence for inclusion of all products within HS 2208 given that some of those products were not even identified to the Panel.

within the HS category of 2208, it could be claimed that the whole issue of the case is decided without any evidence relating to the specific case of Korea. To look at it another way, complainants would like us to establish that all products within 2208, including soju, presumptively are covered and then leave it to Korea to prove that soju is not properly included with respect to the Korean market. This could, in some circumstances, have the practical effect of shifting the burden of proof onto the defending party without the complaining parties having first established a *prima facie* case. It may be that such evidence concerning the whole category could be developed with respect to the Korean market or may exist with respect to other markets, as apparently was the case with respect to the Japanese market, but in this case we can only make determinations with respect to the products specifically discussed by the complainants. These are vodka, whiskies, rum, gin, brandies, cognac, liqueurs, tequila and ad-mixtures.³⁷³ The complainants have not carried their burden of establishing a *prima facie* case with respect to the remainder of the products under HS 2208.³⁷⁴

10.58. We include tequila for which evidence was presented. We note that a third party, Mexico, provided arguments with respect to both tequila and mescal. The complainants provided specific evidence for tequila, but not mescal. We consider it appropriate to take into consideration information provided by a third party. In this case, mescal was mentioned without positive evidence of the actual or potential competitive nature of the product in the Korean market. Tequila was included in the Dodwell study where there was evidence of the response of consumers to the relative changes in the prices of soju and tequila. Tequila is a white alcoholic beverage which is also used, among other things, to accompany spicy foods.

10.59. While we have declined to find all products identified by HS 2208 are included in our determination, we also do not accept the Korean argument that we are required to make an item by item comparison between each imported product and both types of soju. Relying on product categories is appropriate in many cases. Indeed, in this case parties generally referred to the category of "whiskies" which included several subcategories of types of whisky such as Scotch (premium and standard), Irish, Bourbon, Rye, Canadian, etc, all of which have some differences. The question becomes where to draw the boundaries between categories, rather than whether it is appropriate to utilize categories for analytical purposes.

10.60. In our view, it is appropriate to group together all of the imported products for which evidence was presented. We note that Korea in its arguments often referred to western-style beverages. The "high-class" restaurants and bars that allegedly did not serve soju, were said to sell western-style beverages. There are some physical differences between the various imported beverages but, as discussed below, we do not find these differences sufficient to make it inappropriate to group them together as imported products. The prices of the imported products show a spread over a certain range, but as with the relationship to soju, we do not think the prices so distinct as to prohibit us from examining the identified imports as a group. The imports appear to be distributed in similar

³⁷³These are contained within portions of Korea's domestic tariff schedule, as follows:

| | |
|------------|---|
| 2208.20 | Spirits obtained by distilling grape wine or grape marc |
| 2208.30 | Whiskeys |
| 2208.40 | Rum and tafia |
| 2208.50 | Gin and geneva |
| 2208.60 | Vodka |
| 2208.70 | Liqueurs and Cordials |
| 2208.90.10 | Brandies other than that of heading No. 2208.20 |
| 2208.90.40 | Soju |
| 2208.90.70 | Tequila |

³⁷⁴See Appellate Body Report on *United States -- Measures Affecting the Imports of Woven Shirts and Blouses from India*, adopted 25 April 1997, WT/DS33/AB/R, at pp. 12-17.

manners for similar purposes. Therefore, based on the evidence, including that discussed more fully in section 4 below, we find that, on balance, all of the imported products specifically identified by the complainants have sufficient common characteristics, end-uses and channels of distribution and prices to be considered together.³⁷⁵

4. Product comparisons

10.61. We next will consider the various characteristics of the products to assess whether there is a competitive or substitutable relationship between the imported and domestic products and draw conclusions as to whether the nature of any such relationship is direct. We will review the physical characteristics, end-uses including evidence of advertising activities, channels of distribution, price relationships including cross-price elasticities, and any other characteristics.

i) *Physical characteristics*

10.62. Complainants argue that the defining physical characteristic of both imported and domestic products is the fact that they are distilled beverages. Other differences such as colouring or flavouring have no relevance in an analysis of whether products are directly competitive or substitutable. As summarized by the complainants:

The basic physical properties of soju and other categories of liquors concerned in this dispute are essentially the same. All distilled liquors are concentrated forms of alcohol produced by the process of distillation. At the point of distillation, all spirits are nearly identical, which means that the raw materials and methods of distillation have almost no impact on the final product. Post-distillation processes such as ageing, dilution with water or addition of flavourings, do not change the basic fact that the product sold is still a concentrated form of alcohol.³⁷⁶

10.63. Korea argues that the different physical characteristics are substantial. They argue that distilled liquors can be derived from a variety of sources and that the selection of raw materials can play an important role in determining the ultimate qualities of the finished product. Korea argues that there is a distinction between brown spirits such as whisky and white spirits such as soju and gin. The brown colouring generally comes from aging in barrels whereas white spirits are not aged before bottling. Korea argues that even very minor differences in physical characteristics can be determinative if consumers perceive them as important. To put it another way, in response to a question from the panel, Korea argues that two products which are nearly physically identical can be found not directly competitive or substitutable if consumers perceive them differently. According to Korea the question's reference to nearly physically identical begs the question, because "nearly" must be defined in terms of consumer perception rather than comparison of physical characteristics by non-consumers such as chemists.

10.64. We do not agree with Korea's narrow interpretation. The Panel is examining the nature of the competitive relationship and determining whether there is an actual or potential relationship sufficiently direct to come within the strictures of Article III:2, second sentence. The physical characteristics themselves must be reviewed for if two products are physically identical or nearly so, then it obviously means that there is a greater potential for a direct competitive relationship. The United States argued that there can be two products of identical physical properties such as name

³⁷⁵ This decision does not prejudge the substantive discussion; rather we are merely identifying an analytical tool. It is possible that during the course of a dispute, evidence will show that an analytical approach should be revised. In this case, however, we note that the results of the inquiry described in the following sections confirm the appropriateness of grouping the imports together for purposes of analysis.

³⁷⁶ EC First Submission at para. 97; US First Submission at para. 68.

brand and generic aspirin which are marketed somewhat differently and perceived somewhat differently by consumers. Nonetheless, they would be considered directly competitive or substitutable and the identical or nearly identical physical characteristics would be a significant factor in the analysis. We find this analogy useful.

10.65. The panel on *Japan – Taxes on Alcoholic Beverages II* referred to the usefulness of examining marketing strategies.³⁷⁷ Marketing strategies that highlight fundamental product distinctions or, alternatively, underlying similarities may be useful tools for analysis. However, marketing strategies sometimes aim to create distinctions that are primarily perceptual between products with very similar physical characteristics. The existence of such perceptions based on marketing strategies rather than physical similarities and potential end uses does not mean that products are not at least potentially competitive. Indeed, it is natural and logical that marketers would recognize the possibility of capitalizing on the tax differentiation to create a marketing advantage.

10.66. As noted above, we have found it most fruitful to first examine whether the imported products are directly competitive or substitutable and only to turn to the question of whether they are like products second. The determination of whether two products are "like" has traditionally turned to a greater extent (although not exclusively), on the physical characteristics of products. It would be an incorrect reading of the law to argue that products' physical similarities were somehow less relevant for the category of directly competitive or substitutable products than for the subcategory of like products. To put it another way, if two products are physically identical or nearly so, it is highly probable that they are "like." They should not then be found to be not directly competitive or substitutable because marketing campaigns (or government tax regimes) have created a distinction in consumer perceptions. Such consumer perception distinctions are relevant but not determinative when the question is the *nature* of an actual or potential competitive relationship rather than merely a quantitative analysis of the current extent of competition. To find otherwise might allow allegedly discriminatory government measures to create self-justifying product distinctions between identical or nearly identical products.

10.67. We note that for purposes of the analysis under Article III:2, second sentence, products do not need to be identical to be directly competitive or substitutable.³⁷⁸ However, as discussed above, physical similarities are relevant to the inquiry, particularly with respect to potential competition. All the products presented to the Panel have the essential feature of being distilled alcoholic beverages. Indeed, Korea imports ethyl alcohol for use as the base ingredient for diluted soju. Such ethyl alcohol is also used in a similar process for vodka and shochu, among other products.³⁷⁹ All are bottled and labelled in a similar manner.³⁸⁰ In our view, the differences due to the filtration or aging processes of the beverages described are not so important as to render the products non-substitutable. Aging in barrels will impart some flavour to the product as well as a dark colour, usually amber. But differences in color do not render products non-substitutable. We note that rum also is sold in light and dark versions, albeit not as a result of barrel aging. There have been no arguments that the two types of rums are not competitive due to this physical difference. Some beverages have flavourings

³⁷⁷ Report of the Panel on *Japan -- Taxes on Alcoholic Beverages II*, *supra.*, at para. 6.28.

³⁷⁸ Appellate Body Report on *Canada -- Certain Measures Concerning Periodicals*, adopted on 30 July 1997, WT/DS31/AB/R, at p. 28.

³⁷⁹ See para. 6.153 and para.6.161. Korea has argued that this statement takes in too much. It would also imply that certain industrial products might also be like soju or directly competitive or substitutable for it. We agree that this commonality of source material is not, in and of itself, sufficient for our analysis in this case. However, it is a factor which we take into consideration for it does go to show that there is a fundamental similarity in the basic materials used in the manufacturing process.

³⁸⁰ Korea attempted to place a great deal of emphasis on the differences in bottle sizes and labelling. Korea argued that bottles of soju were very different from bottles of shochu which were, according to Korea, made to look more like whisky. We find these differences relatively minor compared to the similarities in presentation.

added, e.g., juniper berries are added to clear spirits to make gin. However, we find that these differences in flavour or colour are relatively minor. We note that soju may also contain various sweeteners and flavourings. Indeed, the premium soju that has entered the market recently, corresponding to the entry of the imported products, has increased amounts of these additives.³⁸¹ While there are some differences in the physical characteristics of the products, weighing the evidence presented, we find that there are fundamental physical similarities between the imported and domestic products that would support a finding that the imported and domestic products in question are directly competitive or substitutable.³⁸²

ii) *End-uses*

10.68. The issue of end-uses for these products has drawn much attention from the parties in this case. The complainants have argued that all distilled beverages have common end-uses. They have identified these as follows:

1. all of them are drunk with the same purposes: thirst quenching, socialization, relaxation, etc.;
2. all of them may be drunk in similar ways: "straight," diluted with water or other non-alcoholic beverages or mixed with other alcoholic beverages;
3. all of them may be consumed before, after or during meals; and
4. all of them may be consumed at home or in public places such as restaurants, bars, etc.

10.69. These are very broad categories of end uses. In response to questions from the Panel, the complainants identified "relaxation" from the concentrated alcohol content as perhaps a defining characteristic. They also responded that such beverages as soft drinks could not be included even though they fit some of the end-uses description because they contained no alcohol.

10.70. Korea has structured its defense primarily around two related aspects of the case. First is price, which will be discussed below. Second is differing end-uses. The two are related because Korea argues that the overwhelming end-use for soju, particularly diluted soju, is drinking with meals in Korean-style and other traditional restaurants whereas western-style beverages allegedly are almost never utilized in such a fashion. One of the reasons, allegedly, for this distinction is the great price differences which make western-style beverages too expensive for such frequent use. There are other reasons put forward by Korea for the end-use distinction as well. For instance, soju is said by Korea to be a harsh drink particularly suitable for drinking with spicy Korean food.³⁸³

10.71. Prior to the second substantive meeting of the Panel, Korea produced a study by the A.C. Nielsen company which Korea argued documented the very distinct end-uses of soju and western-

³⁸¹ See para. 5.55 and para. 7.353.

³⁸² We note that these findings with respect to physical characteristics support our conclusion in section 3, above, that the identified imported products should be considered as a single category.

³⁸³ We note that Korea elsewhere emphasizes the sweetness of soju for purposes of distinguishing it from shochu. (See para.5.55.) Also, Korea submitted a copy of an advertisement for a standard diluted soju which emphasized its mildness. (Attachment 6 to Korean First Submission) This would seem to imply that Koreans would be willing to substitute allegedly less harsh western-style beverages were they to experience them. Furthermore, it is unclear how Korea's emphasis on the lower alcohol level of diluted soju relative to western-style beverages accords with the assertion of its singular harshness. Finally, it also is unclear why food should be seen as necessary to cushion the effect on the stomach of a *lower* alcohol drink compared to a higher alcohol drink.

style beverages. The survey concluded that while all Korean restaurants, Chinese restaurants and mobile street vendors deal in standard soju, most cafes/western-style restaurants and bars deal in whisky. The survey also found that 29.3% of the respondents consumed alcoholic beverages at home with meals, while 81% were found to have consumed such beverages with meals at restaurants. The authors of the report claimed that diluted soju was the predominantly consumed alcoholic beverage with meals. Drinking diluted soju with meals was most popular at Korean restaurants (73%), followed by Japanese restaurants (18.7%). Of the 7 beverages offered to the respondents, none of them were consumed with meals at cafes/western style restaurants, bars and hotel bars. Finally, the survey found that soju is predominantly consumed straight (98.6%), while whisky is usually consumed on the rocks (63.8%).

10.72. The complainants responded to this survey by pointing out that there were several categories of overlapping end-uses. For instance, all Japanese restaurants served soju and 40% of them served whisky; a further 6.7% served brandy or cognac. Of the responding Western-style restaurants and cafes, 90% served whisky and a lesser number served other types of western-style beverages. However, 21.7% served soju. Also, the complainants noted that while only 1.7% of the individual respondents drank whisky at home with meals, only 29.3% of all respondents consumed any alcoholic beverages at home with meals. Therefore, the proper comparison was of the 1.7% with the 29.3%, thus leaving 5.8% of all respondents who consumed alcoholic beverages with meals at home as drinkers of whisky as the accompaniment. Complainants have questioned some of the findings of the Nielsen survey, but also have argued that these results are actually indications of overlapping end-uses.

10.73. Complainants have noted that there were almost no western-style beverages in Korea until the last five years following changes in the duty rates on imported distilled beverages. Furthermore, they argue, alcoholic beverages, like many foods and beverages, are experience based products. People tend to purchase what they are familiar with and change their tastes only over a period of time. They will only make minor substitutions for the familiar product at first and higher frequency will tend to occur over a period of time until a fairly stable rate is achieved.³⁸⁴ The trends shown in the Nielsen survey -- as well as the substitutability shown in the EC's market survey, the Dodwell study -- constitute, according to complainants, unmistakable evidence of the beginnings of substitutability and common end-uses by imports. Trends are significant with respect to such products. We think there is merit in these arguments and further note that this is another reason why the distinction offered by Korea between potential and future competition is too stark. Reasonable projections of increasing substitutability over a period of time are relevant and valid for determinations made pursuant to Article III:2.

10.74. Korea offers an analogy between the alcoholic beverage market and the automobile market which we do not find particularly useful. Korea argues that the imported products are Ferraris compared to soju's Renault Clio. However, the analogy is inapt. Automobiles are durable goods of great value relative to income that are only purchased periodically, generally only once every several years. It is probable that the purchaser of a Renault Clio has no option to purchase a Ferrari which might cost considerably more than the Clio purchaser's annual salary. Alcoholic beverages, on the other hand, are consumer goods which are purchased frequently, and even the Clio purchaser can afford to purchase a bottle of a more expensive beverage at least occasionally. The ratios between \$10 and \$100 products may be the same as between \$10,000 and \$100,000 products, but the purchasing decisions of ordinary consumers in the two situations are quite distinct.

10.75. The EC submitted a market survey conducted by Trendscape during the second substantive meeting of the Panel. It was of the same general type as Korea's Nielsen survey. It examined end-uses but did not go into specific price comparisons as did the earlier submitted Dodwell study. Korea

³⁸⁴ See para. 6.120

requests that we disregard the Trendscape survey. As discussed above, we decline to disregard the survey; however, we do not, in fact, accord much weight to the submission by the EC. It adds little of probative value to the extensive prior submissions of the parties. What was of more interest was the nature of some of the substantive disagreements of the parties concerning information contained in the Trendscape survey. Among other things there was a disagreement over the correct Korean terms and whether the questioners adequately distinguished between "meals" and "food." Korea apparently puts a great deal of store in this distinction, arguing that one must look exclusively at "meals" where Korean soju predominates rather than at mere "food" which might include snacks where western-style beverages might be consumed.

10.76. We do not consider this a meaningful distinction between end-uses of products, certainly not enough to establish separate and non-competing product categories for purposes of Article III:2, second sentence. Neither this nor other panels should be required to draw such fine distinctions permitting significant differences in the application of the law based upon such differences as saying one beverage is used for snacks and another for meals. In reviewing the evidence of this case, we are not convinced that such a distinction, even assuming Korea's argument that it exists is correct, is sufficient. If a distilled alcoholic beverage is drunk with snacks, the nature of the competitive relationship is that it can be drunk with meals, either as marketing campaigns change or persons become more familiar with products new to the market. Indeed, we are unconvinced in general that the distinction between drinking alcoholic beverages at meals and drinking them either before or after meals was, in the context of this case, sufficient to render the products not directly competitive or substitutable.³⁸⁵ Furthermore, we do not agree with the whole concept of basing a distinction on preferences for traditional drinks with traditional meals.³⁸⁶ Korean food may be spicy, but it is not uniquely so in such a manner that soju and only soju is suitable for consumption with meals. It may, in fact, transpire that most Koreans will continue to prefer their traditional drink of soju with traditional food, but based on the information in the surveys and the trends in consumption patterns, it does appear that some Koreans at some times prefer other beverages and that these trends towards substitutability are likely to continue, even with respect to end-use categories we consider overly narrow.

10.77. We also are of the view that the presence of ad-mixtures in the Korean market lends credence to the conclusion of the substitutability of the imported and domestic products. Korea argued that the domestic ad-mixtures are not soju, but as soju is defined in the Liquor Tax Law as essentially diluted ethyl alcohol with some flavorings and additives, it is unclear what point Korea is making with this alleged distinction. If alcoholic beverages can be and often are drunk mixed, either as pre-mixes or

³⁸⁵ Korea attempts to draw a number of product distinctions based on quite narrow differences. For example, Korea drew distinctions between some products based on whether they were given as gifts. Some of these assertions appeared to be contradictory. For instance, Korea stated that a distinction between diluted soju and brandy was that cognac and brandy were generally used as gifts, unlike diluted soju. However, Korea later stated that distilled soju was distinguishable from cognac and brandy because it was used for gifts while cognac and brandy were sold in "high-brow restaurants." (See para. 5.259 and para.5.295) When asked to explain, Korea responded with an even finer distinction as to what occasions particular gift beverages are used for. (See para. 7.358) Korea attempts to draw too fine a line between products for purposes of analysis under Article III:2, second sentence.

³⁸⁶ Korea has argued that the notion that distilled alcoholic beverages are not to be consumed with food is a peculiarly western notion. It is not clear that this assertion concerning "western notions" is necessarily true. Such drinks as vodka and whisky may very well be associated with traditional meals in some of the countries of origin. Furthermore, even if it is true that westerners do not generally drink distilled beverages with meals, it begs the question as to whether Koreans would like to, or sometimes do now, drink western style beverages with their meals. Also, Korea's assertion that "soju is a volume drink; vodka is not" (See para.5.269) could be questionable based on drinking behaviour in other markets. Again, while our decision is in regard to the Korean market, consumption patterns elsewhere are relevant, at least for purposes of assessing potential competitiveness.

mixed after purchase, it shows the potential for substitution between the base drinks and the lack of importance of the distinction which Korea attempts to draw based on alcohol strength.³⁸⁷

10.78. 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. In this regard, we do find it relevant, albeit of less relative evidentiary weight, to consider the nature of the competitive relationship in other markets. If two products compete in a market that is relatively less affected by government tax policies, it might shed light on whether those same two products are potentially competitive in the market in question. Such a comparison is not dispositive by any means; neither should it be ignored. Its relevance consists primarily in whether it tends to corroborate the trends seen in the market in question or whether it reveals inconsistencies with complainants' case which deserve further consideration. In this regard, we note that in Japan there was increasing end-use substitutability between western-style beverages and Japanese shochu as consumers became increasingly familiar with the new product. Both soju and shochu are traditional drinks in their respective countries. Both markets involved small but growing import penetration following partial liberalization. The trends that the panel and Appellate Body observed in Japan appear to be beginning in Korea.

10.79. Article III cases deal with markets³⁸⁸ and the response of Korean producers to changes in the markets provides significant evidence of at least a competitive relationship between soju and the imports. The trend towards increasingly overlapping end-uses are supported by the marketing strategies of the domestic Korean companies. These companies met the potential threat of imports of western-style beverages by creating and selling premium diluted soju. This beverage had more flavourings and was marketed in a manner more similar to western-style beverages than standard diluted soju. However, it remained within the definition of diluted soju in the Korean tax law. The physical characteristics were changed enough to be more similar to such imports while still enjoying the price advantages provided by lower tax rates. The complainants also produced evidence that these products were being advertised as competitive with western-style beverages.³⁸⁹ Indeed, one advertisement referred to soju as a vodka-like product and also showed a new product called barley soju which clearly is intended to be comparable to imported products such as whiskies.³⁹⁰ Evidence was also produced from various sources including Korean Air's in-flight magazine showing very similar advertising strategies for distilled soju and western-style beverages.³⁹¹

10.80. Korea argued that advertisements in Korean Air's in-flight magazine should not be considered as aimed at the broad domestic market. Similarly, according to Korea, information from the website of the largest Korean soju producer, Jinro, in English or other advertisements in Japanese would be aimed at the export market not at the Korean domestic market, which is the only relevant one here. We take note of Korea's criticisms of these materials. However, we continue to disagree that the *only*

³⁸⁷ The question of mixes highlights another of the inconsistencies that emerge from Korea's narrow product-by-product comparisons. For example, Korea argues that an important distinction between soju and vodka is that soju is almost always drunk straight whereas vodka is a mixing drink. (See paras. 5.268-5.269) If this is an important distinction, it would seem an important similarity then between soju and whisky, for example, that the two are often drunk straight. Or if whisky is mixed, it generally is with ice or water which also would seem to highlight the similarity with diluted soju on the basis of alcohol strength of the consumed product. It is also unclear what the basis is for Korea's assertion that vodka is a mixing drink. While it frequently is served that way, it also is served straight.

³⁸⁸ Appellate Body report on *Japan -- Taxes on Alcoholic Beverages II*, *supra.*, at p. 25.

³⁸⁹ See US Exhibits E and F and EC First Submission, Annex 12. See also the Sofres Report, *supra.*, at pp. 23-24.

³⁹⁰ US Exhibit Q.

³⁹¹ US Exhibit D.

relevant market for collecting data is the Korean domestic market.³⁹² Rather the Korean market is the one that is the subject of our decision. In assessing the potential for products to be directly competitive with or substitutable for the domestic products it is relevant to look at how the domestic Korean companies produce, advertise and distribute their products in other markets as well as in Korea. Such evidence may be valuable for confirming or challenging trends and identifying important characteristics of the market which is the subject of the determination. In this case, the trends in the Japanese market where sochu and imported western-style beverages became increasingly used for the same purposes and the behaviour of Korean firms that met the challenge of imports with versions of soju increasingly similar to such imported beverages are relevant confirmation of what exists, albeit in a somewhat nascent form, in the Korean market.

10.81. The issue was raised whether the Panel should use the same criteria for defining markets under Article III:2 as under competition law. Korea was generally supportive of utilizing competition law market definitions for purposes of Article III and even went further and queried whether competition law market definitions might be too broad for purposes of Article III. Complainants argued, on the other hand, that Article III has a different purpose from competition law. Article III, they argue, is an anti-discrimination provision aimed at ensuring that government measures do not result in competitive conditions which favor the domestic industry. Therefore, the interpretation should be broad. According to the complainants, antitrust law has a different purpose of addressing the actions of individual firms or persons that threaten competition and such laws generally do not recognize any distinction between foreign or domestic persons. While the specifics of the interaction between trade and competition law are still being developed, we concur that the market definitions need not be the same. Trade law generally, and Article III in particular, focuses on the promotion of economic opportunities for importers through the elimination of discriminatory governmental measures which impair fair international trade. Thus, trade law addresses the issue of the potentiality to compete. Antitrust law generally focuses on firms' practices or structural modifications which may prevent or restrain or eliminate competition. It is not illogical that markets be defined more broadly when implementing laws primarily designed to protect competitive opportunities than when implementing laws designed to protect the actual mechanisms of competition. In our view, it can thus be appropriate to utilize a broader concept of markets with respect to Article III:2, second sentence, than is used in antitrust law. We also take note of the developments under European Community law in this regard. For instance, under Article 95 of the Treaty of Rome, which is based on the language of Article III, distilled alcoholic beverages have been considered similar or competitive in a series of rulings by the European Court of Justice ("ECJ").³⁹³ On the other hand, in examining a merger under the European Merger Regulation,³⁹⁴ the Commission of the European Communities found that whisky constituted a separate market.³⁹⁵ Similarly, in an Article 95 case, bananas were considered in competition with other fruits.³⁹⁶ However, under EC competition law, bananas constituted a distinct product market.³⁹⁷ We are mindful that the Treaty of Rome is different in scope and purpose from the General Agreement, the similarity of Article 95 and Article III, notwithstanding. Nonetheless, we observe that there is relevance in examining how the ECJ has defined markets in similar situations to

³⁹² It is not clear that all the advertisements were aimed completely outside the Korean market as Korea claims. The advertisements in U.S. Exhibit D appear to be in Korean as well as English.

³⁹³ See *Commission v. France*, Case 168/78, 1980 ECR 347; *Commission v. Kingdom of Denmark*, Case 171/78, 1980 ECR 447; *Commission v. Italian Republic*, Case 319/81, 1983 ECR 601; *Commission v. Hellenic Republic*, Case 230/89, 1991 ECR 1909.

³⁹⁴ Council Regulation No. 4064/89 of 21 December 1989 on the control of concentrations between undertakings.

³⁹⁵ Case No. IV/M 938 – *Guinness/Grand Metropolitan*.

³⁹⁶ *Commission v. Italy*, Case 184/85, 1987 ECR 2013.

³⁹⁷ *United Brands v. Commission*, Case 27/76, 1978 ECR 207.

assist in understanding the relationship between the analysis of non-discrimination provisions and competition law.³⁹⁸

10.82. In making our assessment with respect to degree and nature of overlapping end-uses, we wish to make clear that we are not putting a burden of proving the negative on Korea. Rather, we think that the complainants submitted adequate evidence, *inter alia*, in the form of the Dodwell study, anecdotal evidence, and evidence of trends and results in other markets to establish this portion of their case. We also have taken note of the information in the Nielsen and Trendscape studies. All the beverages described are utilized for socialization purposes in situations where the effect of drinks containing relatively high concentrations of alcohol is desired. They may be used in a variety of social settings, including with food, either meals or otherwise. Korea's attempts to rebut this argument ultimately were unpersuasive. The distinctions that Korea would have us draw are too narrow and transitory. We decline to base a decision on whether a particular type of food is a meal or merely a snack. Indeed, as discussed above, we are sceptical of the whole meal-based rationale which is an important part of the Korean case. In balancing the evidence in this regard, we are mindful of the examples offered by the drafters of Article III and *Ad Article III* who considered apples and oranges directly competitive or substitutable products. Thus, we conclude that, on balance, the evidence is that there are current and potential overlapping end-uses sufficient to be supportive of a finding that the domestic and imported products are directly competitive or substitutable.³⁹⁹

iii) Channels of distribution and points of sale

10.83. There is a considerable degree of overlap between the questions of common end-uses and common channels of distribution. Often, consumer products will be distributed in a manner that reflects their intended end-uses. Channels of distribution tend to reveal present market structure while end-uses deals with both the current overlap, if any, and potential for future overlap. In the present case, it is evident that soju and western-style beverages are currently sold through similar retail outlets in a quite similar manner for off-premise consumption.⁴⁰⁰ Korea has argued that when taken from such outlets soju is consumed differently; this argument is addressed in the preceding section. Similarly, the complainants have shown that there are some similarities in other presumably more minor outlets such as duty free sales.

10.84. The primary area of disagreement is with respect to the channels of distribution for on-premise consumption. Korea argues that soju is sold primarily for use with Korean food in Korean-style restaurants. This was broadened and further explained by Korea through the Nielsen survey, which Korea argues provides evidence that most soju for on-premise consumption was sold to traditional Korean-style restaurants, as well as Japanese and Chinese restaurants and mobile vendors. Conversely, western-style beverages were sold for on-premise consumption primarily to cafes/western-style restaurants and bars.

10.85. As discussed above, the complainants have noted that there was overlapping distribution in the Japanese-style restaurants and cafes/western-style restaurants in Korea's Nielsen survey. We also noted from the Nielsen survey that, with respect to sales to cafes/western-style restaurants, while only 13 of the 60 survey respondents said they sold soju compared with 54 of the 60 saying they sold whisky, they sold 22,710 ml per month of soju compared with 11,702 ml of whisky. That is, more

³⁹⁸ In finding the relationship of the provisions to each other relevant, we do not intend to imply that we have adopted the market definitions defined in these or other ECJ cases for purposes of this decision.

³⁹⁹ We note that the conclusions we reach in this section regarding end-uses supports our conclusion in section 3, above, that the identified imports should be considered a single category.

⁴⁰⁰ US Exhibit G; EC First Submission, Annex 11. See also paras. 6.93-6.94 and 6.188-6.189. We note that this evidence also shows that imports are sold in a similar manner to each other and supports our conclusion in section 3, above.

soju was sold than whisky in this allegedly western-style beverage channel of distribution. This seems to detract from the Korean claim that this type of on-premise channel of distribution overwhelmingly favoured whisky.

10.86. Korea asserted that western-style beverages are limited for on-premise consumption to "classy" establishments such as "high-class" bars, karaoke bars and expensive restaurants.⁴⁰¹ In response to these arguments, the United States sent its embassy personnel in Seoul in search of large, traditional Korean-style restaurants to test the hypothesis. They claim to have found nine such establishments in the vicinity of the US Embassy that sold both whisky and soju. This prompted a discussion among the parties as to whether the identified restaurants would be typical or more expensive than normal. The resolution of the question of whether these restaurants were representative or were too expensive to qualify as "traditional Korean-style" is less important than the nature of the discussion itself. We do not think that a product distinction in a dispute under Article III:2, second sentence, can turn on such a thin and changeable distinction as Korea has attempted to make based on whether a restaurant is "high-class" or "expensive" or not. The only meaningful distinction in channels of distribution and points of sale that came to light in this case was the distinction between on-premise and off-premise distribution, but that distinction does not appear to distinguish between the imported and domestic products at issue. We find that, overall, there is considerable evidence of overlap in channels of distribution and points of sale of these products and such evidence is supportive of a finding that the identified imported and domestic products are directly competitive or substitutable.

(iv) *Prices*

10.87. Complainants have submitted a study of Korean consumer behaviour (the Dodwell study) related to relative price movements of soju and various western-style beverages, including premium Scotch whisky, standard whisky, cognac, vodka, gin, rum, tequila and liqueurs. The Dodwell study purports to show what happens when either the price of soju increases or the price of western-style beverages decreases, both done in specific increments. The survey also attempted to determine whether there was any evidence of cross-price elasticity. In response to Korea's challenges to the data and methodology, the complainants responded that the study was not attempting to show actual calculations of cross-price elasticity ratios because of difficulties inherent in the situation. Complainants said that the imported products had not been available in sufficient quantities to provide adequate consumer familiarity with the products and, furthermore, the Korean tax measures at issue also skewed the pricing and product availability structure such that it would be difficult to calculate actual cross-price elasticity ratios. As noted above, the complainants argued that alcoholic beverages were experience goods. People tend to consume what they are familiar with. Brand and product loyalty are strong and consumers will change their patterns only slowly over a long period of time following significant marketing activity and dependent upon plentiful product availability. Complainants emphasized the statement in the study that it was intended to "determine whether any evidence exists of cross-price elasticity between different spirits categories" rather than actually calculating such elasticities. Complainants referred to this as a more modest goal that was achievable and all that was possible in the circumstances.

10.88. Complainants stated that the evidence of substitutability was quite strong when the two separate trends of lowering import prices and raising soju prices occurred. The United States summarized this in charts which showed the Dodwell results concluding that the respondents would chose imported brown spirits rather than soju 15.22% of the time under current price conditions, but 28.4% of the time when the price of diluted soju was raised 20% and the price of brown spirits was lowered to its lowest point in the survey. Similarly, with respect to white spirits the choice went from

⁴⁰¹ Statement of Korea at First Meeting of the Panel at p. 8; Statement of Korea at Second Meeting of the Panel at p.20.

13.8% for imports at current levels to 23.8% when soju was again increased 20% in price and imports were at their lowest survey levels.⁴⁰²

10.89. Korea provided considerable criticism of the Dodwell study. Citing a EC Commission notice on submissions related to EC competition law, Korea argued that any market study done for the purposes of influencing decision makers must be suspect. Korea also noted that surveys based on asking consumers hypothetical questions about opinions rather than direct factual questions are inherently untrustworthy because, among other things, there may be ambiguity in the questions and there was a need to infer factual results from opinions. Korea also noted that the firm retained to do such a survey has an incentive to try to provide answers consistent with the clients desires so that it might be retained again in the future. Specifically, Korea criticized the complexity of the questions and the unrepresentative nature of the respondents. Korea pointed out a number of anomalies in the results such as *increases* in soju consumption when the price increased from 1,100 won to 1,200 won. Korea also complained that premium diluted soju was included in the alternative samples along with imported beverages rather than included along with standard diluted soju as the base for comparison. According to Korea, this skewed the results. Finally, Korea was critical of the formulation of the questions, which Korea argued could be taken by the survey respondents to mean that they were being asked if they would try a bottle of imported beverages as a one-time purchase if offered a special cut rate price.

10.90. The complainants repeated that the Dodwell study had much more modest purposes than calculating cross-price elasticities for alcoholic beverages in the Korean market. Complainants noted that the Korean market had only been even partially deregulated for a few years and cited the findings of both panels examining Japanese alcoholic beverage taxes to the effect that government regulations and taxes often can freeze consumer preferences. In light of this, according to complainants, it stands to reason that the Dodwell study must be based on a selection of persons who have tried western-style beverages in order that they might have a frame of reference. Because of the recent arrival of western-style beverages in the market, they had to be asked a series of hypothetical questions rather than asking merely for factual information about current behaviour. Also, given the nature of alcoholic beverage purchases as on-going decisions on relatively low cost consumables, it was correct to ask whether the respondents to the survey would be willing to purchase some western-style beverages if prices changed rather than asking them if they would change their fundamental drinking habits. Complainants noted that there always will be statistical anomalies in any survey, but that in the case of the Dodwell study the overall trends were clear even if there was an occasional negative correlation in the data. Finally, complainants have noted that the Dodwell study used the same research methods as the ASI study cited by the panel in *Japan – Taxes on Alcoholic Beverages II*.⁴⁰³

10.91. Korea correctly identifies some of the weaknesses and anomalies in the Dodwell study. The responses move in unexpected directions in some instances. However, on balance, we consider that the Dodwell study provided useful information regarding at least the potential competitiveness of the imported and domestic products. We also do not agree that some of the issues highlighted by Korea are detrimental to the results. We do not find it a flaw that the chosen respondents were not an accurate cross-section of all of Korean society. The surveyors selected 500 men between the ages of 20 and 49 from 3 Korean cities who had purchased soju in the past month and whisky in the past 3 months.⁴⁰⁴ The age, gender and geographic profiles make sense. It is illogical to ask someone if they would shift to another consumer product -- particularly a food or drink item -- following a price change if such a person had never sampled such a product, or a similar one, before and the group chosen seems to be the most likely to have done so. We also agree with complainants about the prospective nature of the questions. If one is asking about the response to potential price changes, it is

⁴⁰²First Submission of the United States at paras. 78-85.

⁴⁰³See Report of the Panel on *Japan – Taxes on Alcoholic Beverages II*, *supra.*, at para. 6.32.

⁴⁰⁴EC Annex 13 at p. 3.

difficult to understand how a question about current behaviour will elicit a useful response. Also, when dealing with a consumable product which has a low price relative to income, it is not necessary that a respondent will permanently change drink preferences. The willingness to occasionally substitute one product for another when there is a relatively high frequency of purchase should be sufficient.

10.92. We must also note a general concern with some of the Korean criticisms of the Dodwell study. Article III serves to protect the expectations of competitive opportunities. Requiring a survey based on current, actual behaviour would prevent a potential market entrant from ever challenging government restrictions.⁴⁰⁵ Indeed, it must be recalled that the Appellate Body confirmed that such surveys are not the decisive factor in decision making under Article III:2, second sentence. We do not find the Dodwell study decisive, but it is consistent with other information and is therefore helpful evidence. When dealing with an inquiry in the nature of the competitive relationship between products, quantitative analysis is helpful, but not necessary.

10.93. There was also considerable disagreement between the parties on the level of price differences between soju and imported western-style beverages. Korea used weighted averages and claimed that whisky was nearly 11 times more expensive than soju, making the effect of the taxes negligible. Complainants responded that the price of standard Scotch whisky was only about three times more expensive than premium diluted soju. On the other hand there were even greater variations with categories such as whisky, for instance between bulk blended-in Korea brands and fine malt Scotches, but Scotch whisky nevertheless was generally considered a single category of beverages. The complainants also argued that because of the high taxes and duties, the imports had tended to be of the higher priced brands thus skewing the numbers used by Korea. Korea further argued that the high priced brand argument was illogical because, unlike the Japanese system of specific duties, the Korean tax system was *ad valorem*. Complainants said that in such a restrictive market, it was not unusual for firms to lead entry into the market with higher priced niche brands to build awareness and sell with an exclusive cachet in segments where premiums could be charged and the consumers had higher incomes and therefore would be relatively less affected by tax levels. Complainants offered some evidence to support their claim by showing consumption patterns of various brands in other selected markets where there was a heavier relative weighting of sales towards lower priced brands than in Korea.⁴⁰⁶

10.94. In examining the evidence before us, we found that, while there currently are significant price differences between the imported and domestic products, overall the differences were not decisive. Korea presented prices as weighted averages which obscured the higher prices for premium diluted soju, which was the small but fast growing category created specifically by Korean manufacturers to be most competitive with imports. The price of premium diluted soju appears to be approximately two times the price of standard diluted soju, while vodka was four times the price and standard whisky four and a half times the price of premium diluted soju.⁴⁰⁷ Distilled soju was twice the price of standard whisky.⁴⁰⁸ There are greater price differences within some categories, e.g., whisky,⁴⁰⁹

⁴⁰⁵ As noted above in our discussion of potential competition, requiring surveys exclusively on current actual behavior would make it even more difficult for less wealthy complainants to establish sufficient actual market presence to establish a *prima facie* case of nullification or impairment.

⁴⁰⁶ See Annex 1 to EC Answers to Questions from the Second meeting of the Panel.

⁴⁰⁷ Thus, vodka was approximately eight times the price of standard diluted soju and standard whisky was approximately nine times the price of standard diluted soju.

⁴⁰⁸ EC Second Submission to the Panel at Annex 7. Also, from the Dodwell study and other evidence it appears that the following are the relationships between the prices of the other products: Gin is approximately 3.25 times the price of premium diluted soju and 6.5 times the price of standard diluted. Tequila is approximately 5.5 times the price of premium diluted soju and 11 times the price of standard diluted. Liqueur is approximately 5 times the price of premium diluted and 10 times the price of standard diluted. Cognac is approximately 12 times the price of premium diluted soju and 24 times the price of standard diluted soju. We

which none of the parties argued rendered such subcategories of products not directly competitive or substitutable. Furthermore, we agree with the complainants that absolute price differences are less important than behavioural changes that occur due to relative price movements.⁴¹⁰ When examined as a whole, the price differences are not so large as to refute the other evidence of potential competitiveness and substitutability, and there was evidence that relative price movements are likely to result in changes in consumption patterns. Overall, we found that the data on prices and the potential for changes in consumer behavior based on relative price changes, to be supportive of a finding that the identified imported and domestic products are directly competitive or substitutable.

(v) *Conclusions with respect to "directly competitive or substitutable"*

10.95. We are of the view that the weight of the evidence overall supports a finding that the imported and domestic products at issue are directly competitive or substitutable. Complainants have sustained their burden of proof in this case by showing that there is some degree of current competition as well as trends towards relative shifts in consumption from soju to the identified imported distilled beverages. The production and marketing decisions of the Korean beverage companies reflect a realization of this in a very concrete manner by the development and rapid success of premium diluted soju. There clearly is an attempt to develop an image of certain types of soju that shows a direct competitive relationship with imported alcoholic beverages. It is probable that there are different marketing focuses (e.g., whether identifying accompaniment with food as a favored mode of consumption) by the importers compared to standard diluted soju; however, marketing strategies alone should not be the basis for finding products not potentially competitive. Marketing strategies can be changed quickly and if there is substantial other evidence that products are potentially directly competitive, it would be incorrect to find them otherwise based on transitory factors such as marketing strategies especially when such strategies can be shaped by the very government policies in question. On the other hand, when two products which have some present market differentiation begin to be marketed in similar fashions, as is happening in the case of the Korean soju makers, it is strong evidence of potential competition. Again, the purpose of Article III is to protect competitive opportunities, not protect actual market shares. Competitive opportunities should encompass the ability to change marketing strategies without the need for beginning a new dispute settlement case. A mere change in marketing strategy cannot be all that distinguishes success from failure of a complaint pursuant to Article III:2. That clearly would be an overly narrow interpretation of the term directly competitive or substitutable.

10.96. The levels of overlapping end-uses are currently relatively low if end-uses are defined as narrowly as suggested by Korea. However, even within such overly-narrow end-use categories, the evidence must be viewed in light of the relatively recent introduction of the western-style beverages to the market. Furthermore, we do not agree with Korea's argument about the distinctness of current market differentiation. We think Korea has drawn too fine a distinction between products for purposes of Article III:2, second sentence. Again we recall the examples of substitutable products

note that Korea offered some lower price comparisons in its Interim Review comments to the effect that vodka was 5.7 times more expensive than diluted soju, while gin was 5 times more expensive and rum 6.2 times more expensive. Korea also stated that cognac/brandy was 19.2 times the price of diluted soju. Korea did not indicate if weighted averaging caused these differences from the figures above.

We note that in the decision in *Japan – Taxes on Alcoholic Beverages II*, adjustments were made for alcohol content. Panel Report in *Japan – Taxes on Alcoholic Beverages II, supra.*, Annex VI, Figure 10. When such adjustments are removed, it seems that the absolute price ratio differentials in the present case are more similar to those in Japan than otherwise appears.

⁴⁰⁹ See para.6.105; Dodwell Study.

⁴¹⁰ Indeed, we must reiterate that caution must be exercised in relying on absolute price ratio differences in making product distinctions in a market such as this. Prices can respond to extraneous factors such as exchange rates or can be affected through product mix or high overhead or distribution costs possibly caused in part by the government policies at issue.

offered by the drafters, which included apples and oranges. This also can be seen in the significantly overlapping channels of distribution both for off-premise sales and on-premise sales. In our view, the only meaningful distinction with respect to channels of distribution in this case is the distinction between on-premise and off-premise consumption and both imports and soju are distributed through both channels.

10.97. There is evidence both of some level of current actual competition and significant potential competition. However, complainants do not have to prove that there is a complete overlap in their analysis of substitutability. Moreover, we take guidance from the earlier panel findings that the current market conditions may be skewed by government tax and regulatory policies which tend to freeze consumer preferences in favour of the domestic products. The current price levels are probably the most telling evidence contrary to complainants assertions. In our view, the Dodwell study is a useful piece of evidence showing the potential competitive relationship between the domestic and imported products under various pricing scenarios. It is not perfect evidence, but we do not find the Korean critique conclusive in rebutting its basic premises. Indeed, we find confirmation of some of the basic points about potential competitiveness in both the Korean end-use survey conducted by the AC Nielsen study and the Trendscape survey. Furthermore, we do not accept that the price differences in the present case establish that the products in question are not even potential competitors. Prices are subject to change by extraneous factors such as exchange rates.

10.98. We are of the view that there is sufficient unrebutted evidence in this case to show present direct competition between the products. Furthermore, we are of the view that the complainants also have shown a strong potentially direct competitive relationship. Thus, on balance, we find that the evidence concerning physical characteristics, end-uses, channels of distribution and pricing, leads us to conclude that the imported and domestic products are directly competitive or substitutable.

5. Not similarly taxed

10.99. The Appellate Body in *Japan – Taxes on Alcoholic Beverages II* summed up its findings with respect to this element of the decision as follows:

Thus, 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

10.100. In the present case, the Liquor Taxes on diluted soju are 35 percent and 50 percent on distilled soju. The Education Tax is surtax of 10 percent levied on soju. With respect to imported alcoholic beverages, the Liquor Tax ranges from 50 percent for liqueurs to 100 percent for whisky and brandy. The Education Tax is 30 percent for all imported alcoholic beverages except liqueurs which have a 10 percent rate. Thus the total tax on diluted soju is 38.5 percent; on distilled soju and liqueurs it is 55 percent; on vodka, gin, rum, tequila and ad-mixtures it is 104 percent; on whisky, brandy and cognac it is 130 percent. Thus the tax rate on imported whisky, for example, is more than three times the *ad valorem* rate on diluted soju. These differentials are clearly in excess of *de minimis* levels.⁴¹²

⁴¹¹ Appellate Body Report on *Japan -- Taxes on Alcoholic Beverages*, *supra.*, at p. 27. It should be noted that in the case of Japan, the duties were specific and there was an ultimately unsuccessful argument by Japan that the tax/price ratios were not dissimilar. Because Korea's taxes are strictly *ad valorem*, the rates are more easily comparable and there is no such issue.

⁴¹² The fact that distilled soju and liqueurs are taxed at the same rate does not detract from this finding with respect to the other products and with respect to liqueurs compared to diluted soju.

6. So as to afford protection

10.101. The Appellate Body in the *Japan Alcoholic Beverages* case stated that the focus of this portion of the inquiry should be on the objective factors underlying the tax measure in question including its design, architecture and the revealing structure.⁴¹³ In that case, the Panel and the Appellate Body found that the very magnitude of the dissimilar taxation supported a finding that it was applied so as to afford protection. In the present case, the Korean tax law also has very large differences in levels of taxation, large enough, in our view, also to support such a finding.

10.102. In addition to the very large levels of tax differentials, we also note that the structures of the Liquor Tax Law and the Education Tax Law are consistent with this finding. The structure of the Liquor Tax Law itself is discriminatory. It is based on a very broad generic definition which is defined as soju and then there are specific exceptions corresponding very closely to one or more characteristics of imported beverages that are used to identify products which receive higher tax rates. There is virtually no imported soju so the beneficiaries of this structure are almost exclusively domestic producers.⁴¹⁴ Thus, in our view, the design, architecture and structure of the Korean alcoholic beverages tax laws (including the Education Tax as it is applied in a differential manner to imported and domestic products) afford protection to domestic production. We therefore conclude that there is nullification or impairment of the benefits accruing to the complainants under GATT 1994 within the meaning of Article 3.8 of the DSU.

7. Like Product

10.103. The complainants in this case argued that vodka is like soju.⁴¹⁵ Korea disagreed.⁴¹⁶ We note that there are many similarities between vodka and soju and that these are sufficient to establish that the products are directly competitive or substitutable. However, as the Appellate Body found in *Japan – Taxes on Alcoholic Beverages II*, the concept of "likeness" in Article III:2, first sentence, is to be narrowly construed.⁴¹⁷ The question is whether the products are sufficiently close in nature that they fit within this narrow category.

10.104. We find that there is insufficient evidence in this case to make a determination that vodka and soju are like products. We do not find that they are "unlike". Rather we find that there is insufficient evidence in the record of this case to establish that they are like. In making this finding, we recall that the Appellate Body also noted that a determination of whether vodka was like shochu or was instead only directly competitive or substitutable did "not materially affect the outcome of [the] case."⁴¹⁸ We find this conclusion equally valid in the facts of the case at hand. Thus, while we have found that vodka and the other identified imported distilled alcoholic beverages and the domestic products are directly competitive or substitutable, we are unable to conclude that the imported products, or any subcategory of them, are like the domestic products.

⁴¹³ Appellate Body Report, on *Japan -- Taxes on Alcoholic Beverages II*, *supra.*, at p. 29. See also *Canada - Certain Measures Concerning Periodicals*, *supra.*, at pp. 30-32.

⁴¹⁴ The only domestic product which falls into a higher category that corresponds to one type of imported beverage is distilled soju which represents less than one percent of Korean production.

⁴¹⁵ See para. 5.100et. seq.

⁴¹⁶ See para. 5.264et. seq. and para. 5.296 et. seq.

⁴¹⁷ Appellate Body Report on *Japan – Taxes on Alcoholic Beverages II*, *supra.*, at p. 21.

⁴¹⁸ *Ibid.*

XI. CONCLUSIONS

11.1. In light of the findings above, we reached the conclusion that soju (diluted and distilled), whiskies, brandies, cognac, rum, gin, vodka, tequila, liqueurs and ad-mixtures are directly competitive or substitutable products. Korea has taxed the imported products in a dissimilar manner and the tax differential is more than *de minimis*. Finally, the dissimilar taxation is applied in a manner so as to afford protection to domestic production.

11.2. We recommend that the Dispute Settlement Body request Korea to bring the Liquor Tax Law and the Education Tax Law into conformity with its obligations under the General Agreement on Tariffs and Trade 1994.
