

to actual on-shelf retail prices paid by consumers. On the other hand, Japan recognizes that the key determinant in assessing tax/price equivalency is the price that the consumer actually pays, not a notional price obtained from a manufacturer's pamphlet that suggests a retail price. Thus, notional retail prices of distilled liquor do not reflect the reality of the consumer marketplace and consequently do not accurately reflect tax/price ratios arising from the tax differentials under the Liquor Tax Act. In any event, the tax/price ratios submitted by Japan do not come close to being "roughly the same at around 20 per cent of the expense for the tax". In fact, the ratios for the various categories of distilled liquors encompass a widely divergent range of ratios. Thus, for example, the tax/price ratio for Shochu B is a claimed 13 per cent, almost one third lower than the claimed tax-price ratio for imported whisky of 19 per cent. For Canada, Japan's assertion that the tax differentials under the Liquor Tax Law yield equal tax/price ratios is simply without foundation.

(2) Canada argued that the evidence is equally unambiguous on the source of shochu production. In 1987, 99.3 per cent of domestic sales of shochu Group A were derived from domestic production. In 1994, that amount declined modestly to 96.9 per cent. Regarding shochu B, 99.9 per cent of sales were derived from domestic production. In 1994, the figure remained unchanged. Accordingly, shochu continues to be almost exclusively produced in Japan. The evidence also indicates that shochu and whisky are mutually substitutable. Therefore, Canada argued the Liquor Tax Law "affords protection to domestic production" of shochu Group A and shochu Group B within the meaning of Article III:2, second sentence.

(3) On the cross-price elasticity, Canada referred to its argumentation developed under the first step of its legal test in paragraphs 4.90 and following, namely that shochu and Canadian whisky are substitutable and directly competitive.

4.101 **Canada** argued that an examination of the relationship between the differential specific tax rates on whisky and shochu and the resulting effects on price competitiveness between the two products makes it manifestly clear that the Liquor Tax Law is inconsistent with the observation of the Working Party Report on Border Tax Adjustments and confirmed in the 1987 Panel Report, that internal taxes must be trade neutral. The Liquor Tax Law is not trade neutral. It distorts the relative prices of whisky and shochu. It, thereby, distorts the competitive relationship between these two products and consequently affords protection to shochu production in contravention of Article III:2, second sentence. Canada submitted that price is a crucial element in determining the competitive relationship between shochu and whisky. Thus, it is significant that retail prices of imported whisky are responsive to changes in liquor tax rates. Accordingly, in Japan, the specific tax rates imposed pursuant to the Liquor Tax Law have a direct effect on the prices of imported whisky and, consequently, on the competitive relationship between this product category and shochu.

4.102 **Canada** added that given the findings in the 1987 Panel Report that even small tax differences can influence the competitive relationship between directly competing distilled liquors, the significant differences in the tax burdens imposed by the tax differentials under the current Liquor Tax Law affecting the price of imported whisky, *a fortiori* magnify the distortions in the competitive relationship between shochu and whiskies. Indeed, given the nexus between specific tax rates, the price of imported whisky and, ultimately, the competitive relationship between shochu and whisky, the significance of these large tax differentials in distorting the competitive relationship between shochu and whisky is made clear when considered against the retail price of imported whisky and shochu and thus, the domestic market "value" ascribed to these products. Since 1989, the tax rate on whisky has remained constant. During this period of time, and indeed since 1987, the retail price on imported whisky has rapidly declined. Thus, for whisky, the tax rate has not responded to changes in domestic market value. By contrast, Canada submitted that in 1994 there was a modest increase in the tax rate levied on shochu corresponding

to a small increase since 1987 in the retail price of this product. Unlike shochu, the net result of the specific tax rates imposed on whisky pursuant to the Liquor Tax Law is that as the retail price, and thus the domestic market value, of imported whisky has fallen, the tax portion of the retail price has increased. Canada argued that, since 1989, the liquor tax on imported whisky is consuming an ever-increasing portion of the retail price. As described in one survey of retail prices in Japan, even though the retail price of formerly Special Grade imported whisky has proportionately decreased by an amount greater than the increase in the retail price of shochu, the tax burden levied pursuant to the Liquor Tax Law on this whisky product has proportionately increased by an amount greater than that imposed on shochu. Given the fact that price is a crucial element in determining the competitive relationship between whisky and shochu, the tax burden levied on imported whisky, not reflecting its market “value”, hinders the price movement of imported whisky and hence the ability of imported whisky to compete with shochu. Canada submitted that to render neutral the proportionate differential tax burdens imposed on shochu and whiskies, the retail price of imported whisky would have to increase by a proportionate amount thereby decreasing the ability of imported whisky to compete with shochu in Japan’s domestic market. In short, Canada argued that by imposing differential tax burdens on shochu and whisky that do not reflect the market value of imported whisky, the tax rates imposed on shochu and whisky pursuant to the Liquor Tax Law distort the competitive relationship between these two product categories and thus, cannot be claimed to be trade neutral.

4.103 **Japan** responded that Canada did not satisfy the three last criteria for its legal test under Article III:2, second sentence. Japan admitted that the liquor tax is an internal tax (first criterion of Canada’s test). For Japan, as argued with the Community, shochu and whisky are not directly competitive or substitutable (second criterion). In discussing whether or not the products are similarly taxed (third criterion), Canada compares the amount of the tax per one litre of the products or per alcohol contained. However, Japan argued that in light of the emphasis Canada repeatedly attached to the price as a crucial element in determining the competitive relationship between shochu and whisky, the comparison ought to be made on the basis of the tax burden in relation to the price. By this standard, Japan argued that shochu and whisky are similarly taxed. Canada’s fourth criterion “of affording protection” is, again, not met, in Japan’s view, since tax/price ratios are roughly equal between imported whisky and domestic shochu: In restoring the balance in tax/price ratio between whisky and shochu in the 1994 reform, Japan chose to increase tax on shochu, not to reduce tax on whisky, for fiscal reasons, but both methods are equally effective in restoring the balance. Japan stressed that what is relevant to the purpose of neutrality and equity is relative relations of tax/price ratios among categories, not the absolute level of the ratios *per se*.

4.104 In addition, **Canada** argued that the Superfund panel report has established the principle that a finding of fiscal distortion in the competitive relationship between imported and domestic products constitutes an “irrefutable presumption” of nullification and impairment of benefits. While the Superfund panel report spoke in terms of Article III:2, first sentence, the 1987 Panel Report and the 1992 Malt Beverages panel report established that the same principle applies equally to Article III:2, second sentence. For Canada, this principle has been codified in Article 3:8 of the DSU, which provides:

“In cases where there is an infringement of the obligations assumed under a covered agreement, the action is considered *prima facie* to constitute a case of nullification or impairment. This means that there is normally a presumption that a breach of the rules has an adverse impact on other Members parties to that covered agreement, and in such case, it shall be up to the Member against whom the complaint has been brought to rebut the charge”.

Of the presumption of “an adverse impact”, the panel report in the Superfund<sup>70</sup> case and the 1987 Panel Report<sup>71</sup> enunciate the principle that overall increases in market share for imports of the products in issue does not constitute a rebuttal. Indeed, the Superfund case articulates the principle that a finding of fiscal distortion in the competitive relationship between imported and domestic products constitutes an “irrefutable presumption” of nullification and impairment of benefits. The 1987 Panel Report determined that the factors set out in paragraph 4.94 above *ipso facto* constitute “sufficient evidence of fiscal distortions of the competitive relationship between imported distilled liquors and domestic shochu”. In view of the conclusive evidence described in paragraphs 4.72 to 4.93, including, more specifically, the positive evidence of cross-price elasticity between shochu and other imported distilled liquors, it necessarily follows, in Canada’s view, that the Liquor Tax Law distorts the competitive relationship between imported distilled liquors and domestically produced shochu, and therefore is inconsistent with the second sentence of Article III:2. Canada noted that indeed, Japan’s Deregulation Subcommittee of the Administrative Reform Council, an independent advisory body whose members are appointed by Japan’s Prime Minister and approved by the Diet, stated that the tax rates under the Liquor Tax Law constitute “virtual restrictions on the buyer’s activities” and are not “neutral in relation to consumer choice”.

4.105 **Japan** responded that the criterion unique to Canada’s test is distortion of the competitive relationship and that it is noteworthy that Canada’s argument rests on distortion of relative prices. Accurate data show, however, that the Liquor Tax Law does not distort relative prices between whisky and shochu, and, accordingly, this criterion of distortive effects is not met. In order to reach a finding of inconsistency with Article III, all of Canada’s criteria would have to be met, but it was not the case, since Canada had not proven that shochu and Canadian whisky are directly competitive, that shochu and Canadian whisky are not similarly taxed, or that the Liquor Tax Law affords protection to domestic production. For Japan, Canada had, therefore, not proven that the Liquor Tax Law is inconsistent with Article III:2, even under Canada’s interpretation of the provision.

#### **F. Application to the Present Case of the Legal Analysis Suggested by the United States for the Interpretation of Article III:2**

4.106 As argued in paragraphs 4.24 to 4.32 above, the **United States** submitted that the central concern of Article III is to prohibit the targeting of imports and suggested that application to the Liquor Tax Law of the aim-and-effect test of earlier panel reports would confirm the inconsistency of that measure with the provisions of Article III:2, second sentence, in that the regulatory distinctions made by the legislation are so as to afford protection.

##### **1. The Aim of the Legislation**

4.107 The **United States** argued that the protective aim of the Liquor Tax Law structure is apparent from (1) the stated policy objective and whether it was known at the time the legislation was enacted that it would draw a line between one group of products that would be foreign and another group that

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<sup>70</sup>Thus, in the Superfund case, para. 5.19, the panel stated: “A demonstration that a measure inconsistent with Article III:2, first sentence, has no or insignificant effects would therefore in the view of the Panel not be a sufficient demonstration that the benefits accruing under the provision had not been nullified or impaired even if such rebuttal were in principle permitted”.

<sup>71</sup>The 1987 Panel Report stated in para. 5.16: “[A]n increase in imports could not refute the presumption that discriminatory or protective taxes inconsistent with Article III:2 had impaired the competitive benefits protected under Article III:2 because, *inter alia*, an increase in imports did say nothing about what the trade might have been in the absence of the inconsistent trade restrictions”.

would be domestic (*ex-ante* knowledge), (2) the internal inconsistencies of the legislation and its structural incentives, (3) legislative statements and the preparatory work, as well as from (4) the arbitrary and irrational categories of the legislation under scrutiny. The United States continued by stating that:

(1) During the consultations, the Japanese Government asserted that the policy objective of the Liquor Tax Law system was to maximize tax revenue while ensuring that the tax is distributed among consumers in accordance with their “tax-bearing ability”. However, this objective is nowhere stated in the law, which has no general statement of purpose other than “Taxes shall be imposed on alcoholic beverages in accordance with this law”. The taxes provided for by the Liquor Tax Law are specific taxes, with no link between the tax rate and the actual price of the alcoholic beverage in question; their structure does not support the claim that they are designed to effectuate equity between categories of spirits. To base tax rates on consumers’ tax-bearing ability assumes that some products are consumed by the masses and should be low-priced, and other products are exotic luxuries consumed by the rich who can afford to be taxed heavily; this proposition was specifically rejected by the 1987 Panel Report. For the United States, statements connected with the 1994 revision of the Liquor Tax Law also offer a sample of the motivations behind enactment of this legislation. The official records of deliberations in the Finance Committee of the Diet in March 1994 show that Ministry of Finance Tax Bureau Director Ogawa testified that the reason for the difference in tax treatment was “out of consideration for the higher material costs etc” of shochu B. He also testified that particular attention had been made to coordinate the tax increases with the increased costs of raw materials associated with factors such as the poor rice harvest in the case of refined sake and shochu, especially shochu B. The legislation raising taxes included as well an extension of tax reductions for small-volume producers of shochu A and B, and provision for a subsidy fund for shochu producers. The package in context demonstrates that the operative consideration in passing the legislation was the economic well-being of domestic shochu producers, not a neutral tax policy.

(2) According to an article in a Ministry of Finance publication written by one of the Ministry drafters explaining the 1962 revisions,<sup>72</sup> the definitions were changed at that time in order to clarify and reinforce the distinction between shochu, whisky, brandy and spirits. The purpose of the change and the related exception was (a) to exclude certain products which would be classified as whisky, brandy, and spirits, but since dates were already being used as a raw material for shochu in Japan, these would be permitted as a fruit raw material for shochu; (b) to exclude vodka; (c) to exclude rum from the category of shochu, but permit Okinawan awamori made with barrel molasses to remain as shochu; (d) to exclude gin and similar genever-type drinks.

(3) The lack of any policy rationale other than protection is apparent from the otherwise-arbitrary distinctions drawn in the product categories. The only difference between vodka and shochu A is that according to the definition in the Liquor Tax Law, shochu A cannot be filtered with white birch charcoal, although it can be filtered with any other material. Yet the tax rate on vodka is 2.55 times higher than the tax rate on shochu A. The Japanese government has never claimed that the ban on the use of white birch charcoal in filtering shochu was based on health reasons or any other policy. Thus the distinction cannot have any purpose other than excluding imported vodka from the tax benefits granted to the producers of shochu.

(4) It is also arbitrary to set the maximum alcohol content for shochu made by continuous distillation methods (shochu A) at 36 per cent and the maximum alcohol content for shochu distilled otherwise

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<sup>72</sup>Tan Hirosho, “Shuzeiho to no ichibu o kaisei suru horitsu” (The Law Partially Revising the Liquor Tax Law), in *Zeisei Tsushin* (Tax Policy News), June 1962, p. 23ff. The article identifies the author as the Deputy Director of the Ministry of Finance, Second Tax Policy Division.

(shochu B) at 45 per cent. All alcoholic beverages falling within the categories of "shochu", "whisky/brandy" and "spirits" are classified as "liqueurs" and taxed at a uniform rate whenever they are pre-mixed with a sugared non-alcoholic beverage. However, the same alcoholic beverages, when sold undiluted, are classified within different tax categories and taxed at widely differing rates, even though they are often consumed in home-made mixes made with similar non-alcoholic beverages. Again, in the US view, the Japanese government has claimed no policy justification for this difference in taxation. The only rational explanation for it is that pre-mixes, unlike undiluted alcoholic beverages, are produced almost exclusively in Japan. For the United States, the arbitrariness of the distinction drawn between "spirits" and shochu can be seen in the recent move by Suntory, the producer of "Juhyo" brand vodka, to re-characterize it as shochu A. Before June 1993, Juhyo was sold as vodka, and accounted for almost half of Japanese vodka production. After June 1993, Suntory ceased using birch charcoal as a filtering material, and began selling Juhyo as shochu A, simply in order to reduce the tax burden on the product. Suntory was then able to, and did, reduce the retail price of Juhyo. Of course, because of the substantial tariffs on shochu, it is not possible for foreign vodka producers to do the same. Thus, for the United States, the distinction drawn by the system of Japanese liquor taxation between shochu and all other distilled spirits is arbitrary and contrived.

4.108 **Japan** responded that the complaining parties seemed to confuse the present Japanese policy, as explained in the bilateral consultation, with that of 1987. Japan argued that it had not referred to the notion of the tax-bearing ability in bilateral consultation. The essence of the policy in 1987 was: "Since whisky consumers have a greater tax-bearing ability than shochu consumers, the tax/price ratio ought to be higher for whisky than for shochu." In contrast, the present tax policy since the 1989 amendment is: "Tax/price ratio should be roughly constant between whisky and shochu for the sake of ensuring neutrality to consumers' choice and of equity in between consumers of these products". Examining excise taxes in view of the three criteria of neutrality, horizontal equity and vertical equity is common practice among tax authorities in the world, though which of the three is prioritized may differ according to prevailing socio-economic conditions: for example, the report on excise taxes issued by the United States' Congressional Budget Office in 1990 starts its discussion with the examination of the three criteria. The lack of statements of policy goals in the Liquor Tax Law is only a standard practice of tax legislation in Japan, and, for example, introducing the 1989 amendment before the National Diet, the Minister of Finance stated, "The fundamental principles of the present amendment are to ensure equity in distribution of the tax burden and to maintain neutrality toward economic activities". Japan further argued that the evidence cited by the United States is part of the record of Diet deliberations of the 1994 amendment. The amendments cannot conceivably have had a protective intent, however; it raised the tax rate for shochu A by 30 per cent, that for shochu B by 44 per cent, while raising the tax on "spirits" by a mere 11 per cent, but maintained the tax on whisky/brandy at the same level. The 1962 material written by the person who prepared the Liquor Tax Law merely referred to the problem common to any product classification and so did other alleged evidence of arbitrariness. The amendments of 1989 and 1994 which substantially raised the tax on shochu B refute, *ipso facto*, the allegation of policy distortion by local political forces. This led Japan to conclude that speculative inside stories are not appropriate as the basis for panel findings. Most whisky, brandy and spirits consumed in Japan are manufactured locally. For example, the rate of domestic production of whisky is 75 per cent, that of brandy, 72 per cent, and that of "spirits", 82 per cent. These categories cannot be equated with imports as such. Categorization of these products, therefore, is not the targeting of imports as the United States claims. The tariff on shochu (currently 17.9 per cent, same as that on vodka and lower than that on rum) is irrelevant to the issues of Article III. Moreover, for Japan, the categories are not exceptional or arbitrary. It is arbitrary, according to the US submission, to distinguish vodka from shochu on the basis of filtration with white birch charcoal, but Japan responded that any legal definition of a product encounters similar difficulty in translating a socially accepted concept. It is no more indicative of protective intent than the Community definition of sparkling wine

on the basis of mushroom stoppers. Japan continued in asserting that different rates of ceiling on the alcoholic strength of shochu A and B result similarly from the task of defining products. Eight different threshold levels of strength are established for various product categories in the Community definition directive. Japan did not believe that this renders the Community rule protectionist.

4.109 **Japan** continued its counter argument on the aims of the legislation, in stating that it is not arbitrary to apply the same tax rate to pre-mixes, while subjecting unmixed original products to different rates; Canada while applying different rates on distilled liquors and wine, applies the same rate on distilled liquor based pre-mixes and on wine based pre-mixes. The recharacterization of the “Juhyo” brand vodka into shochu by the manufacturer is, in essence, marketing of two different products under the same brand name, and does not indicate arbitrariness in categorization. The shochu product is produced from a different set of materials and is marketed as a New Juhyo. For Japan, this should be looked at as an attempt to take advantage of a popular brand name. Suntory, the manufacturer of Juhyo brand, sells Reserve whisky and Reserve wine. The Liquor Tax Law is not “the legislation that draws a line between one group of products that would be foreign and another group that would be domestic”. Whisky, spirits and liqueur have been produced in large quantities in Japan, and, therefore, are not foreign, while shochu is produced in large quantities in the Asian region, and is, therefore, not domestic. Finally, the Liquor Tax Law is designed to be neutral and does not have incentives in any direction. Thus, none of the factors supporting a protective aim have been shown. For Japan, all of the evidence supplied by the United States on arbitrary or exceptional categorization is, in fact, evidence of the difficulty common to all legal definitions of social concepts.

4.110 For the **United States**, the tax rate applicable to any particular alcoholic beverage in Japan is a function of its classification, the applicable tax rate, and any available exemptions or reductions. The definition of “shochu” was devised in 1962 when all Japanese import trade was subject to BOP quotas and imported shochu was nonexistent, in order to reserve low tax rates for an exclusively-domestic product category. In the US view, it was absolutely clear in 1962 that the definition of shochu would exclude imported distilled spirits, and would form part of a system favouring shochu through the tax rate. This categorization was designed to perpetuate the market situation of 1962. Ever since 1962, shochu A and particularly shochu B have benefited from the lowest tax rates on distilled spirits. The effect has been to cement into place distinctions made under conditions of perfect protection, and to perpetuate the closed market of the pre-liberalization period. The discrimination in tax rates was reduced but not eliminated after the 1987 Panel Report. Shochu could still be characterized as a Japanese product benefiting from discriminatory low tax rates. Indeed, the United States argued, when a system of tax classifications had been designed during such a period of absolute protection, the categorization of products based on their status during the quota period had to be re-evaluated after balance-of-payments quotas had been lifted. The tax discrimination still remained: ¥982.3 per litre for whisky and brandy versus ¥102.1 per litre for shochu B, and ¥367.3 per litre for spirits versus ¥155.7 per litre for shochu A. Japan has offered no convincing policy rationale for this differential. The United States cited a statement by the Japanese Government’s own Administrative Reform Council admitting that there is at present no logical rationale for the Liquor Tax Law, and no plausible explanation for the liquor tax system including the segmentation of categories and tax rates.

4.111 The **United States** also argued that if a tax strongly favours a product of which all, or almost all, the amount consumed is produced domestically, but not another which is directly competitive or substitutable, a protective purpose may be inferred. The 1992 Malt Beverages panel report, in discussing the special tax treatment accorded by Mississippi to wine made from scuppernong grapes, noted that even if this wine were considered unlike other wine, the two kinds of wine would nevertheless have to be regarded as “directly competitive” products in terms of the Interpretative Note to Article III:2, second sentence, and the imposition of a higher tax on directly competing imported wine so as to afford

protection to domestic production would be inconsistent with that provision. The United States also pointed to the sudden or dramatic difference in rates at the margin under the Liquor Tax Law which resulted in large differences in treatment of products on either side of the line drawn between shochu and other distilled spirits. The rates on shochu A and B are still much lower than the rates on other distilled spirits. There is still a 9.6 to 1 tax differential between whisky and shochu B, a 6.3 to 1 differential between whisky and shochu A, and a 2.4 to 1 differential between spirits and shochu A, at the respective reference alcoholic strength for each. The United States stated that the Liquor Tax Law targets the inherent characteristics of the product so that foreign manufacturers of gin or rum cannot make a product that has access to the lower tax rate without changing the nature of their product.

4.112 **Japan** responded that the tax rates currently applied to distilled liquors are completely different from those in 1962. Japan also argued that the Administrative Reform Committee's comment concerns the taxation of alcoholic beverages as a whole, and contains no specific reference to distilled liquors. For Japan, their critique of shortcomings in Japan's taxation of alcoholic beverages as a whole would be in fact valid for any liquor tax in the world. It is true that there is room for improvement, but no tax is perfect. In response to the United States condemnation on "the sudden or dramatic difference in rates at the margin", Japan argued that such difference is common to most tax distinctions: the rate of the US tax on wine jumps from \$1.07 to \$3.40 when the carbon dioxide in the wine crosses the threshold of 0.392g per 100 ml. Japan further argued that 75 per cent of whisky, 72 per cent of brandy, 82 per cent of spirits and 97 per cent of liqueur consumed in Japan is produced domestically. It is, therefore, farfetched to assume an element of targeting of imports behind these categories or taxes. With respect to whisky, in particular, Japan is the fifth largest producer in the world. Japan suggested that it cannot possibly target imports by taxing the category. Japan submitted that imports are not targeted and if the central concern of Article III:2 is the targeting of imports, as the United States argues, the lack of targeting is enough to establish that Japan's Liquor Tax Law is consistent with Article III. In support of its argument Japan referred the Panel to a chart showing the "Share of Domestic Production of Liquors in Total Sales in Japan" (see Annex IV).

## **2. The Effect of the Legislation**

4.113 The **United States** went on to argue that the distinction drawn by the Liquor Tax Law also has the effect of affording protection to domestic production. In this regard, data on sales and trade flows are relevant to show changes in the conditions of competition favouring domestic products. Other factors, including the creation of inherently domestic products and foreign products, and whether there is a large difference in rates between categories, also support the conclusion of a protective effect. In this context, the United States referred the Panel to some of the conclusions of the 1987 Panel Report which found that: 1) consumer habits varied in response to the respective prices of shochu and other distilled spirits, their availability through trade and their other competitive inter-relationships (i.e., substantial cross-elasticity of demand existed between these products); 2) the increasing imports of Western-style alcoholic beverages into Japan bore witness to this lasting competitive relationship and to the potential product substitution through trade among various alcoholic beverages; and 3) there existed direct competition or substitutability among imported and Japanese-made distilled liquors, including all grades of whiskies/brandies, vodka and shochu A and B, in terms of Article III:2, second sentence. The 1987 Panel Report found as well that the following factors were "sufficient evidence of fiscal distortions of the competitive relationship between imported distilled liquors and domestic shochu affording protection to the domestic production of shochu": a) the large difference in specific tax rates between the taxes on shochu and the taxes on imported distilled spirits; b) the fact that shochu was almost exclusively produced in Japan and that the lower taxation of shochu afforded protection to domestic production, rather than to a product produced in many countries; and c) the mutual

substitutability of distilled liquors, as demonstrated by the increasing imports into Japan of distilled spirits and the consumer use of shochu in mixed drinks. For the United States an examination of the effect of the Liquor Tax Law in this present case should focus on qualitative alteration of conditions of competition such as targeting of imports, and evidence of cross-elasticity of demand between the favoured and disfavoured categories.

4.114 The **United States** pointed out that shochu consumed in Japan continues to be made almost exclusively in Japan. In 1994, imports of shochu were 1.7 per cent of total sales and 1 per cent of total sales of distilled spirits and “authentic distilled spirits”. Also, in 1994, imports from third countries accounted for 27 per cent of the total sales of whisky, 29 per cent of the total sales of brandy, 18 per cent of the total sales of spirits and 78 per cent of the total sales of “authentic liqueurs”. At the same time, domestically-made shochu accounted for over 80 per cent of all domestic sales of distilled spirits and authentic liqueurs. Thus, the protection given to shochu has had the effect of protection for domestic production.

4.115 On the market shares of shochu and the price-cross elasticity of shochu, the **United States**, in addition to the arguments detailed in paragraphs 4.82 to 4.93 above, noted that there were clear indications that the demand for shochu is largely influenced by fluctuations in demand for other distilled spirits and liqueurs. This could be seen in the rearrangement of the market place for distilled spirits after the 1989 tax reform. The 1989 reform unified tax rates on whisky, abolished the classification of whisky into three classes, and consequently more than tripled the tax rate on second-class whisky while lowering the taxes on other whisky, authentic liqueurs and spirits. The 1989 law also raised the tax on shochu by a small amount. In particular the United States submitted that:

- Retail prices for second-class whisky almost doubled, and the market share for domestic whisky declined from 27 per cent in 1988 to 19.6 per cent in 1990. This trend has continued: in 1994 the market share of domestic whisky sank further, to only 13.2 per cent. Shochu makers were able to move into the place in the market formerly held by second-class whisky. Sales of shochu have steadily increased and reached 74.2 per cent of distilled spirits in 1994.
- The prices of imported whisky, liqueurs and spirits declined and their sales rose. However, Japan entered a recession in 1992. The highest-taxed categories, whisky/brandy, authentic liqueurs and spirits, were hit worst and have lost sales both relatively and absolutely since 1992, while the market share of shochu continues to grow at their expense.
- Because the prices of shochu and other distilled spirits have partially converged, their cross-elasticity of demand has risen.
- Shochu continues to be made almost exclusively in Japan. In 1994, imports of shochu were 1.7 per cent of total sales and 1 per cent of total sales of distilled spirits and “authentic distilled spirits”. Also in 1994, imports from third countries accounted for 27 per cent of the total sales of whisky, 29 per cent of the total sales of brandy, 18 per cent of the total sales of spirits and 78 per cent of the total sales of “authentic liqueurs”. At the same time domestically-made shochu accounted for over 80 per cent of all domestic sales of distilled spirits and authentic liqueurs. Thus, the protection given to shochu has had the effect of protection for domestic production.

4.116 In support of its allegation of the protective effect of the Liquor Tax Law, the **United States** argued that there is a sudden or dramatic difference in rates at the margin. The rates on shochu A and B are still much lower than the rates on other distilled spirits. The United States noted that there