

**PHILIPPINES – TAXES ON DISTILLED SPIRITS
(DS396/DS403)**

**EXECUTIVE SUMMARY OF THE
OPENING STATEMENT OF THE UNITED STATES OF AMERICA
AT THE SECOND SUBSTANTIVE MEETING OF THE PANEL**

FEBRUARY 17, 2011

1. We are now in the later stages of the litigation process, and the issues are clear. As the Philippines stated in its second written submission, it is indeed a moment to reflect.

A. The United States Claims Concern Particular Measures of the Philippines, Not Its Fiscal Policies or Economic Development

2. The United States requested this Panel to examine two specific claims under the *General Agreement on Tariffs and Trade 1994* (“GATT 1994”), with respect to particular tax measures of the Philippines. The question before the Panel is whether the Philippine tax system for distilled spirits is inconsistent with the Philippines’ WTO obligations under the first and second sentences of Article III:2 of the GATT 1994.

3. The U.S. claims make no statement on the Philippines’ broader fiscal policies, its needs, or what specific changes the Philippines should adopt to its tax system. All the parties to this dispute – including the Philippines – recognize that, as the Appellate Body in *Japan – Alcohol* stated:

Members of the WTO are free to pursue their own domestic goals through internal taxation or regulation so long as they do not do so in a way that violates Article III or any of the other commitments they have made in the *WTO Agreement*.

4. However, the Philippines’ defense of its measure neglects the second part of that citation – the one which is critical to the parties’ claims: *so long as they do not do so in a way that violates Article III or any of the other commitments they have made in the WTO Agreement*.

5. In the first paragraph of its most recent submission, the Philippines states that the “central issue” before the Panel is “whether Article III of the GATT 1994 should be interpreted and applied in a way that prohibits the Philippines from following a fiscal policy that best fits its needs.” To the contrary, that is not the central issue in this dispute: the central issue is whether the Philippine measures are consistent with its WTO commitments.

6. In our statement today, the United States will discuss several specific aspects of the Philippine arguments:

- First, the Philippines' grouping of distilled spirits into "sugar based" and "non sugar based" does not accurately reflect its measures or its own arguments;
- Second, Article III of the GATT 1994 does not require a showing of discrimination in a "majority" market segment;
- Finally, the size of the tax differential between imported and domestic products is sufficient to determine whether the differential is "de minimis".

B. The Philippines' "Sugar-Based" and "Non-Sugar-Based" Terms Do Not Accurately Reflect Its Measures or Its Own Arguments

1. The Measures Favor Alcohol Produced from Several Typical Philippine Raw Materials – Not Just "Sugar"

7. From its very first submission to this Panel, the Philippines has used the terms "sugar based" and "non sugar based" broadly to describe two groups of distilled spirits sold in the Philippines. But these terms not only are very rough shorthand for products of the different raw materials favored by the Philippine measures, they also are misleading in the context of the Philippine economic arguments.

8. The Philippines acknowledges that "sugar-based" is not a precise description of the criteria its measures use to distinguish between products. That much is true.

9. Section 141 of the Philippines' Internal Revenue Code neatly divides the universe of distilled spirits into two categories "A" and "B". "A" describes lower-taxed products and "B" includes everything else.

10. The measures do not define the products eligible for inclusion in Category "A" and therefore entitled to the lower tax rate as "low cost" or "sugar-based." Rather, it has two specific requirements.

11. First, a category A product must be manufactured from one of six different raw materials – nipa, coconut, cassava, camote, buri palm, or sugar cane. As the complainants have shown, about the only thing these materials have in common is that they are produced in the Philippines.

12. Second, the raw material must be commercially produced in the country where the distilled spirit is manufactured. The Philippines has described how this does not require that the raw material actually be produced in the Philippines; yet the United States is not claiming that it does. Rather, as the United States has explained, this requirement further limits the imported distilled spirits that might qualify for favorable tax treatment and prevents producers in many

Members from being able to qualify for the lower tax rate even if they use one of the favored raw materials. For example, a distilled spirit made from palm or camote fails to qualify for the low tax rate if the producer is unable to show that it is located in a country that commercially produces palm or camote. Any Philippine producer, on the other hand, need not worry about this requirement because all the favored raw materials are produced in the Philippines.

13. In short, category “A” is a proxy, not for “sugar based,” but for “local.” In fact, this is evident from the annexes in the Philippines’ own regulations, which repeatedly refer to products classified under category “A” as “local.” It is important to take a step back from the submissions and consider this terminology, because the Philippines’ defense of its measures depends on accepting the premise that its measures are designed to provide more favorable tax rates to preserve the affordability of certain distilled spirits – in fact, its measures are designed to provide lower taxes to local products, *i.e.* protect domestic production.

2. Notwithstanding Differences in Raw Materials, Imported and Domestic Products Are “Like” or “Directly Competitive or Substitutable”

14. When the Philippines examines physical differences between imported and domestic products, it focuses almost exclusively on attributes of the raw materials. Yet even as it claims that products made from different raw materials are distinguishable because there is an “inextricable link” between a product and its raw materials, it acknowledges that there is “some comparability” between products made from different raw materials, and that additives may be added to sugar cane products to “create a flavor comparable to the flavor of a non-sugar-based spirit.”

15. Indeed, in the Philippines, raw materials are reduced to ethyl alcohol, a “neutral spirit” for which the attributes of the raw material have been eliminated as much as possible. Ethyl alcohol can be made from the sugars *of any raw material*, as pointed out by the responses to the Panel’s first question to the parties. In the Philippines, this stripped down, neutral product is transformed into more recognizable consumer products through the use of additives. As the Philippines noted with regard to whiskey in its first written submission, “the original flavour of the sugar material is extinguished as much as possible” and “local distillers add the relevant flavourings and ingredients” to neutral spirits “to generate the taste of whiskey.”

16. Unlike the products at issue in *Japan – Alcohol*, which were not reduced to a neutral spirit only to have flavors added to produce the final product, in the case of the Philippines, the products are reduced to a neutral ethyl alcohol, which is then used to produce a variety of products that are like or directly competitive or substitutable with imported products. To the extent there is a link between a distilled spirit and its raw material, Philippine producers have done their best to break it.

17. The nature of the Philippine products at issue also informs the structure of the particular

measures at issue. Unlike measures such as those examined in earlier alcohol tax disputes that protected one “type” of distilled spirit such as sochu or pisco, the Philippine tax system enables Philippine producers to make essentially any type of end product and enjoy favorable tax treatment, as long as they start with a stripped down, neutral spirit made from the right kind of raw material. The examples provided by the complainants – including information regarding labels, store displays, end use, etc. – show that the types of products that Philippine producers create from neutral spirits made from local raw materials are essentially the same type of products that importers offer to Philippine consumers.

18. The United States has presented evidence to the Panel demonstrating the similarities between imported and domestic products in the Philippine market. The United States has also provided evidence demonstrating how the measures apply to these products. The measures cover all types of distilled spirits, and group together products from local raw materials in one category, and all other products in another. Accordingly, the United States has provided evidence with respect to different types of products (such as whiskey and gin) from both categories, demonstrating that imported and domestic products are like and directly competitive or substitutable and that the measures accord less favorable treatment to imported products.

3. The Philippine Measures Do Not Distinguish between Products Based on Price

19. The Philippines uses the term “sugar based” not only as shorthand for the longer list of six local raw materials named in its measures, but also in its arguments concerning the purported lack of competition between domestic and imported products due to differences in price. These arguments are equally flawed.

20. As an example, at paragraph 53 of its second written submission, the Philippines asserts that the “price differential between non-sugar-based distilled spirits and sugar-based distilled spirits compared to the income of the great majority of Filipinos prevents consumers from the majority market from considering non-sugar-based distilled spirits as an ‘alternative way[] of satisfying a particular need or taste.’” Yet the Philippine measures discriminate on the basis of raw material, not price. In fact, the only differentiation by value included in the Philippine measures is the three progressively higher rates applied to products not made from local types of raw materials.

21. Indeed, if the measures were designed to favor consumers of a certain income level or purchasing power, there would be no reason to structure the tax around the raw material used to manufacture the distilled spirit – the measure could just distinguish between products based on their price without regard to raw material.

22. Two things are clear: the Philippines applies lower taxes to products made from local raw materials, and Philippine producers go to great lengths to obscure the differences between

products manufactured from different raw material sources. The raw materials that make products eligible for favorable treatment under the Philippine measures do not distinguish between products that are not like, but distinguish between products that are domestic and imported. The measures “afford protection to domestic production”.

4. The Philippine Tax Measures Are Difficult to Administer

23. The Philippines has made several points about administrative capacity – suggesting that the current system may be justified or necessary as a matter of what is feasible for its government in order to meet its objectives. These assertions, when one looks at the measures themselves, simply do not ring true.

24. The tax system imposed through the Philippine measures is actually extremely complicated. The system is set out not only in the basic provisions of the Internal Revenue Code, but also in a number of regulations predating and subsequent to the 2004 law, as well as implementing annexes. These measures set out in detail, brand by brand, applicable tax information involving assessments of raw material, price, and alcohol content. In addition, to maintain currentness, the Philippine measures provide for regular surveys.

25. It is not particularly obvious how the system works, and the Philippine differentiation of products based on raw materials – when the price information is also collected and employed – adds an additional layer with no apparent purpose except the protection of its domestic industry.

26. Moreover, the repeated updates to one of the Philippines’ key exhibits bears scrutiny in light of its assertions about administrative capacity. The Philippines has updated Exhibit PH-19 twice, once of its own accord and then, at least in part, apparently in reaction to specific data highlighted by the complainants.

27. The data in the exhibit are the kind of information the Philippine government is apparently supposed to keep track of simply in order to maintain its current system. Yet in the context of the current dispute, the exhibit with this cross section of products – not even all products as listed in the multiple regulations and annexes of the Philippine measures – has been beset with problems. Plainly it is not a simple task to keep all this straight.

28. We would like to make one additional point about the “corrected” exhibit. The Philippine correction changes the information that the United States used to identify a product that – but for the discriminatory taxation imposed by the Philippines – would be less expensive than a domestic product of the same type. Even setting aside this one example does not disturb the larger point the United States was making: the Philippine “sugar based” and “non-sugar based” categories are not reasonable proxies for affordable versus expensive products, nor are its markets so segmented as to prevent competition between imported and domestic products.

29. There are domestic products in the Philippine market at higher costs, and also a range of prices for imported products. Even the “corrected” Exhibit-77 includes relatively higher-priced domestic brands (*e.g.* Napoleon VSOP) and relatively lower priced imports (*e.g.* Myers Rum Original Dark). The range of prices in the Philippines own regulations also is revealing. For example, Revenue Regulations 23-2003 lists net retail prices for a long list of imported brands, including low-price (*e.g.*, Cherry Brandy Walsh at 61.43 pesos, net of taxes, for 750 mililiters and Jose de Soto Brandy de Jerez Solera, at 185 pesos, net of taxes, for 700 mililiters) along with high-price brands like Hennessy cognacs. The regulations also reflect higher-priced domestic brands such as Napoleon VSOP (with a price net of tax for 750 mililiters of 127.98 in Revenue Regulation 02-07 of 1997).

C. A Finding of WTO-Inconsistency Under Article III of the GATT 1994 Does Not Require a Showing of Discrimination in a “Majority” Market Segment

30. The United States would now like to draw the Panel’s attention to another aspect of the Philippine approach that is not consistent with the GATT 1994. The Philippines argues, particularly in its most recent submission, that the United States must show competition among imported and domestic products in the “majority” of the Philippine market in order to demonstrate that imported products are directly competitive or substitutable with local products.

31. There is no such requirement in Article III of the GATT 1994, nor is the Philippine position supported by the reasoning of prior panels or the Appellate Body. First, prior panels have been clear that latent, or potential, demand is a consideration in determining whether goods are directly competitive or substitutable. Thus, the fact that a majority of Filipinos – or any Filipinos – might not currently purchase imported distilled spirits does not mean that the products are not directly competitive or substitutable. Further, the factors for whether goods are directly competitive or substitutable focus on the goods themselves – particularly attributes like end-use. Under the Philippine proposed interpretation, a Panel would discount the attributes of the goods themselves, whether they are substitutes and how they would be used by consumers.

32. The United States notes that a measure may be WTO-inconsistent even where the products in question are only substitutes for a subset of consumers. For example, suppose only 10% of Filipinos drink distilled spirits at all – for those 9 million-plus consumers, WTO rules obligate the Philippines not to discriminate against imported distilled spirits sold in the Philippines. As such, the Philippine arguments about the “majority” market would not change the appropriate findings in this dispute, even if they were valid. And even under the Philippine proposed approach, the Philippines implicitly concedes that the imported and domestic distilled spirits compete in at least “part” of the Philippine market since the Philippine references to a “majority” market concedes that there is a “minority” market.

33. In understanding how the Philippine proposed approach proceeds from the wrong basis not only legally but also economically, it may be helpful to consider the distilled spirits market in

the Philippines generally as it is affected by the tax measures. In response to the Philippines' characterization of its majority market as lower-income consumers, and, by assumption, consumers of lower-taxed local brands, the United States would like to offer some further analysis of the Philippine market.

34. The Philippine market is dominated by less expensive domestic brands. Imported brands are largely absent at any price point. According to the Philippines, the reason for this is the low purchasing power of the majority of Filipino consumers. However, a closer look at the brands sold in the Philippines bears out the significant barrier that the Philippine taxes present to importers seeking to sell products at a lower price point in the Philippines. The lack of imported brands at the lower end of the price spectrum should not signify that they do not have potential to do so.

35. The top five brands (all domestic) accounted for 86% of the Philippine market in 2010. While price, as measured in cost per liter, will vary according to package size, brand and retail outlet, the mid-point of each brand was between 80 and 116 Pesos per liter.

36. With 86% of all volume selling well below 250 Pesos per liter, the low end segment of the Philippine market is clearly important.

37. As of 2011 the excise tax on spirits produced from favored raw materials was only 14.68 Pesos per proof liter, while the *lowest* possible excise tax on other products was 158.73 Pesos per proof liter.

38. For almost every individual brand in the top 86 percent of sales, the difference between the domestic tax and the tax that would be paid on a comparable imported brand is more than 50% of the retail price. For 13 of the 23 brands the difference between the tax on domestic and imported distilled spirits is more than 80% of the retail price. The simple average is 73%.

39. The impact of the tax on imported products is clearly a barrier to imported products seeking to sell at a lower price point. For example, if a brand were imported at the same supplier price as Ginebra San Miguel, it would sell for 86 Pesos per liter *if* the domestic tax were applied. However, the higher tax rate would add 115 Pesos to the retail price. Thus, an imported product would have a retail price of 201 Pesos per liter – 133% higher than the domestic brand.

40. Clearly, the excise tax on imports currently precludes imported products from competing with domestic brands in this segment of the market. The Philippine measures create significant price differences for these products. On the Philippines' theory of showing competitiveness in the majority market, imported products would need to have made further progress in market penetration already, simply to make a case under the national treatment provisions of the GATT 1994.

41. The United States offers this information to demonstrate the challenge that the Philippine taxes present to importers whose products are subject to higher taxes. Beyond these taxes, the Philippine market presents significant opportunities for imports. There is a generally well-developed market for distilled spirits in the Philippines. Consumer choices have changed over time, showing dynamism in the market. For example, Philippine consumers switched from gin to brandy in significant volumes between 1999 and 2009, even though brandy was consistently priced at levels much higher than that of gin. And Philippine producers continue to introduce new vodkas and whiskies into the market, including premium brands.

D. The Size of the Tax Differential Between Imported and Domestic Products Is Sufficient to Determine Whether the Differential is “De Minimis”

42. Finally, the United States would like to make a few comments on the Philippine proposed approach to “de minimis” and “direct competition.”

43. A finding that a measure is WTO-inconsistent under the second sentence of Article III:2 of the GATT 1994 requires a showing that the difference in taxation between directly competitive or substitutable products is more than “de minimis.” The Philippines argues that “de minimis” is a market-based concept.

44. By this, the Philippines means that the Panel should examine whether the difference in taxation between the so-called “sugar based” and “non sugar based” distilled spirits affect consumers’ choices. This reading could lead to extreme results – for example, a Member could have an explicitly discriminatory measure and, so long as the measure was put in place before there was significant import penetration, the Member could with impunity use that measure to prevent imports from competing on an equal footing and gaining market share.

45. The Philippines claims that one cannot use the size of the tax differential to determine whether it is “de minimis” – but this plainly does not make sense. The tax rates concerned are at the heart of its measures, and indeed, past panels have found that the size of the tax differential alone may be sufficient to show that the discrimination under a measure is more than de minimis.¹

46. Accordingly, the U.S. suggestion that the Panel focus on the size of the differential is sound. Here, again, focusing on the specific Philippine measures, the tax per proof liter for products not made from local types of raw materials is from ten to forty times higher than that applied to local raw materials and dwarfs the price differentials found to be over “de minimis” in other disputes on Article III:2 of the GATT 1994.

47. The Philippine approach is similar to a “trade effects” test, as the United States described

¹ *Japan – Alcohol (AB)*, p. 29-30. See also *Korea – Alcohol (Panel)*, para. 10.101.

in its response to questions from the Panel and in spite of the Philippine claims to the contrary. In this, it is similar to the Philippine approach on the issues of like product and directly competitive or substitutable products – that is, if consumers might not purchase more imports in the absence of the discriminatory tax, the products are not substitutes or like for the purposes of GATT Article III.

E. Conclusion

48. To conclude our remarks this morning, the United States would ask the Panel to reflect on the interpretation of the measures which makes the most sense. The Philippine approach would present its measures as an easily administrable, progressive tax system for low-cost distilled spirits. The United States sees a complex tax structure which effectively distinguishes between local and imported products and taxes the imported products at much higher rates. The United States sees a group of measures that afford protection to domestic production in breach of Article III of the GATT 1994.