PHILIPPINES – TAXES ON DISTILLED SPIRITS

(DS396/DS403)

EXECUTIVE SUMMARY OF SECOND WRITTEN SUBMISSION OF THE UNITED STATES OF AMERICA

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I. INTRODUCTION

1. This dispute concerns two specific legal claims relating to fundamental obligations under the *General Agreement on Tariffs and Trade 1994* ("GATT 1994") and a discriminatory tax system that has been in place in the Philippines for decades. Article III:2 of the GATT 1994 has been the subject of multiple DSB recommendations and rulings, and the United States has presented the Panel with a clear, straightforward demonstration of why the Philippines measures are inconsistent with Article III:2, using analysis that is consistent with the approach taken by prior panels, but suited for the particular facts of the Philippine measures and market.

2. In this submission, the United States will briefly discuss the issue of the scope of "like product" and "directly competitive or substitutable" products in the context of the Philippine measures. Following that discussion, the United States will provide further comments on several of the main points presented by the Philippines: alleged segmentation of the market; administrative capacity of the Philippines; treatment of rum; and evidentiary concerns.

II. EVIDENCE BEFORE THE PANEL SHOWS THAT THE PHILIPPINE MEASURES ARE INCONSISTENT WITH ARTICLE III:2 OF GATT 1994, FIRST AND SECOND SENTENCES

3. As the United States has explained in its previous submissions, the first and second sentences of GATT 1994 Article III:2 are separate obligations with different elements. The first sentence concerns "like" products. In order to establish that a measure is inconsistent with Article III:2, first sentence, one must demonstrate two specific elements: *first*, that the imported and domestic products are "like," and *second*, that the imported products are taxed "in excess of" the like domestic products.

4. The second sentence concerns "directly competitive or substitutable" products. Per the note *Ad* Article III:2, establishing that a measure is inconsistent with Article III:2, second sentence requires: *first*, that the imported products are directly competitive or substitutable with the domestic products; *second*, that domestic products and imported products are not similarly taxed, and *third*, that the dissimilar taxation is applied so as to protect domestic production.

5. The first element of the claim under each sentence of Article III:2 – "like product" and "directly competitive or substitutable" product, respectively – concerns the substitutability between imported and domestic products. Panels have used similar factors in examining similarities among products under both claims, applying the factors on a case-by-case basis as appropriate for the particular market. Panels have used factors "such as the product's properties, nature and quality, and its end-uses; consumers' tastes and habits, which change from country to country; and the product's classification in tariff nomenclatures."

6. Contrary to the suggestions by the Philippines, the complainants have provided ample evidence to the Panel demonstrating the "likeness" and the "direct competitiveness or substitutability" of Philippine and imported brands.

7. The United States provided information on the physical characteristics of imported and Philippine vodka, brandy, whiskey, gin, rum, and tequila, through evidence such as the Philippines own standards (vodka, whiskey, and brandy), similarity of alcohol content (with specific evidence provided for brands of brandy, whiskey, vodka, gin, rum, and tequila), and photographic comparisons (type by type, of Philippine and imported brands of tequila, brandy, whiskey, gin, and vodka). Particularly in the context of the Philippine market – where the local producers make the same "type" of product as the importers – this evidence shows strong similarities between imported and domestic goods.

8. In addition to the information on physical characteristics, the United States provided extensive evidence showing that imported and domestic products are marketed similarly and sold in the same channels of distribution. Particularly telling are store displays where imported products are sold – they appear in example after example side by side with domestic products, and with different types of spirits all displayed together. In addition, some of the labels of imported and domestic brands are so similar as to be difficult to tell apart.

9. End uses is another critical factor, particularly with regard to concluding that products are directly competitive or substitutable under the second sentence of Article III:2 of the GATT 1994. While the conclusion that the products have similar end uses is obvious from the fact that the Philippine and imported products are the same types (brandy, vodka, etc.), the United States has submitted survey analysis that provides additional support for this conclusion. The Euromonitor survey results – which cover all domestic and imported types of spirits – confirm that Filipino distilled spirits consumers use imported and domestic brands for the same end uses. Moreover, the information on elasticity of demand in the Euromonitor survey and in the Philippines' own study show that if prices of more expensive imports go down, Filipinos are more likely to choose them over local brands. This effect, though modest in both analyses, is real and supports the conclusion that the Philippine and imported products are substitutes.

10. Finally, as all parties acknowledge, distilled spirits are classified under the same four digit heading in the Harmonized Tariff System. Although not definitive, tariff classification can be an important factor concerning similarity among products recognized by other panels and the Appellate Body.

11. No single factor for "likeness" or "directly competitive or substitutable" is required or determinative. Panels have weighed them on a case-by-case basis. In this dispute, the Panel has evidence before it in all relevant areas – physical characteristics, marketing/channels of distribution, end use, price elasticity, and tariff schedule – to support findings regarding Philippine products.

12. The remaining elements of the claims under Article III:2 both concern the extent of the discriminatory treatment of like/directly competitive or substitutable products. Here also there should be no question that the Panel has ample evidence before it.

13. To find that the Philippine measures are inconsistent with the first sentence of Article III:2, the second element simply requires showing that the imported products are taxed in excess of domestic products. This conclusion is evident from the face of the measures – including the implementing annexes, which separate "local" from other brands. These documents show that nearly every imported product is taxed at one of the high rates – from ten to 40 times the rate applied to local products on a proof liter basis.

14. To find that the Philippine measures are inconsistent with the second sentence of Article III:2, the second element requires evidence showing that the difference in taxation between imported and domestic products is more than *de minimis* and that the dissimilar taxation is applied so as to protect domestic production.

15. As noted above and the United States has stated before, the rate applied to products not made from favored local-type raw materials far exceeds the rate applied to other products; and the magnitude of the discrimination far exceeds that found to be inconsistent with the GATT 1994 in prior disputes. Magnitude alone may be sufficient to conclude that a measure is applied "so as to protect domestic production" under the second sentence of Article III:2 of the GATT 1994.

16. But in addition, the structure of the measures also favors discrimination on a very broad basis: because the measures are based on raw material, Philippine producers can use favored raw materials to make different types of products (*e.g.*, vodka or gin) to compete against imports as the market changes and retain their favorable treatment. On the other side, foreign firms that use the types of raw materials apparently favored by the Philippines – such as rum producers – still only receive equal tax treatment if they successfully navigate bureaucratic obstacles. The measures are structured to continue to favor domestic production.

17. To conclude, the United States has presented more than sufficient evidence to the Panel on which to draw the conclusion that the Philippine measures are inconsistent with WTO obligations that the Philippines has undertaken. In the remainder of this submission, the United States will discuss the appropriate parameters for these findings, and respond to several specific points raised by the Philippines.

III. SCOPE OF LIKE AND DIRECTLY COMPETITIVE OR SUBSTITUTABLE DISTILLED SPIRITS

18. In this dispute, the question of what is "like" and what is "directly competitive or substitutable" depends on the particular facts and circumstances of the Philippine measures and market. In the Philippine market, the types of distilled spirits manufactured locally are the same types (*e.g.*, whiskey) as those imported from abroad for sale in the Philippines. The Philippines has acknowledged that "all sugar-based distilled spirits are labeled with the generic category name for the distilled spirit" (*e.g.*, "whiskey").

19. Philippine manufacturers also adapt to changes in the marketplace by developing new types of products – based on "neutral spirits," stripped of the attributes of the raw material so that it can be flavored with essences, extracts or other additives. For example, Ginebra San Miguel Corporation has introduced several different types of beverages in the last several years (*e.g.*, vodka, whisky), which are taxed at the favorable rate because of the raw material used. In addition, Philippine companies have introduced different versions of their products, including "premium" varieties aimed at more elite consumers.

20. In other distilled spirits disputes under Article III:2 of the GATT 1994, the complainants were concerned with the treatment of imported spirits compared to a particular type of domestic spirit. In that situation, the particular domestic distilled spirit can be examined against the products it is *most* similar to ("like products"). Then, the particular domestic distilled spirit can be examined against a wider, expanded circle of products to see whether the domestic distilled spirit is "directly competitive or substitutable" with additional products that it may not be "like." The line between products with which the domestic distilled spirit is "like" and the products with which the domestic distilled spirit is "directly competitive or substitutable" is a line between the products it is *most* similar to and other products that it is less similar to but are nonetheless directly competitive or substitutable.

21. A different type of analysis is appropriate for the Philippines, because the same types of spirits are made in the Philippines and imported from abroad. Indeed, applying the analysis from other disputes, it is unclear why there is any question at all in this dispute. Whereas in the other disputes, the complainant might pose the questions "Is vodka 'like' shochu?" or "Is pisco 'directly competitive or substitutable' with whiskey?," an analagous question here is "Is whiskey 'like' whiskey?" The answer is "yes."

22. Given this particular situation, the United States has provided evidence comparing particular imported and Philippine distilled spirits brands of different types. These examples show that the difference between imported and domestic brands that is decisive for the discrimination under the Philippine excise taxes – raw material – is not in any way apparent to a consumer, and that the obvious answer to the question "Is whiskey 'like' whiskey?" – yes – is the correct one. This is equally true for all types of products in the Philippines – brandy, vodka, etc. In this way, for each product within HS 2208, the United States has demonstrated that a "like product" exists in the Philippines that is taxed more favorably than the imported product.

23. As to which products are "directly competitive or substitutable" and which products are "like," the United States notes that prior panels and the Appellate Body have consistently recognized "like product" as narrower than "directly competitive or substitutable." Further, the Panel's analysis may depend on the order in which it analyzes the first and second sentences of Article III:2. In particular, there is no need to analyze whether "like products" are also "directly competitive or substitutable." That conclusion follows from their "likeness."

24. The United States is specifically requesting findings covering all distilled spirits under both the first and second sentences of Article III:2 of the GATT 1994, but in different ways. With respect to the first sentence, the United States asks the Panel to review the evidence of Philippine domestic brands and their imported counterparts to confirm that Philippine "brandy" is like imported "brandy," Philippine "gin" is like imported "gin," etc. With respect to the second sentence of Article III:2, the United States requests that the Panel find that all imported distilled spirits are directly competitive or substitutable with all Philippine distilled spirits.

25. This is consistent with the conclusion reached for distilled spirits by three other panels: different types of distilled spirits (*e.g.*, brandy, vodka) are "directly competitive or substitutable" with one another. The findings in the individual disputes vary in the details, including scope of products covered, but each was clear regarding the substitutability among distilled spirits from type to type. The panel in *Chile – Alcohol* found pisco directly competitive or substitutable with products falling under HS 2208, the panel in *Korea – Alcohol* found soju, whisky, brandy, cognac, rum, gin, vodka, tequila, liqueurs and ad-mixtures directly competitive or substitutable, and the panel in *Japan – Alcohol* found soju directly competitive or substitutable with whisky, brandy, rum, gin, genever and liqueurs.

26. The Philippines suggests that the complainants' arguments should fail because of a lack of evidence, even going so far as to suggest that it is a critical flaw to focus on particular brands. But this type of evidence – and its existence in the Philippines – is the result of the Philippines' domestic production of the same types of spirits as imported spirits. As such, examples of Philippine gin juxtaposed against imported gin, or Philippine vodka juxtaposed against imported vodka are not just isolated examples – they are a demonstration of the kind of competition that exists in the Philippines, the operation of its measure, and the discrimination in the Philippines market. As such, they are particularly compelling evidence of the barriers to the market (*e.g.*, Philippine brands like "London Gin") faced by producers outside the Philippines.

27. Even so, the Panel has not only the particular examples of different brands, but also other evidence, including regulations concerning sales of distilled spirits (covering *all* distilled spirits) and store displays showing different types displayed together. The United States has also provided survey evidence on end uses, reflecting data on all types of distilled spirits. The Euromonitor Report grouped data for different types of products together, broadly showing the similarities among uses across imported and domestic products. In fact, the same conclusions can be drawn from the data on end use collected by Euromonitor when separated by type of spirit. Generally, Filipinos consume imported and domestic products in similar ways. These data demonstrate that imported and domestic brands of distilled spirits are alternative ways to satisfy the same needs and tastes. Finally, the grouping of distilled spirits in the Harmonized System is itself a factor indicative of their similarity.

28. For both the first and second sentences of Article III:2, the conclusion should be guided by the ample evidence and the Philippine measures themselves, which cover all distilled spirits. Under the measure, the Philippine domestic manufacturers can – and do – manufacture any type

of distilled spirit and may enjoy the benefits of favorable tax treatment. Accordingly, the Panel's findings should cover the same scope of products.

IV. ACCEPTING THE PHILIPPINES' MARKET SEGMENTATION ARGUMENTS WOULD PRESERVE THE STATUS QUO OF WTO-INCONSISTENT DISCRIMINATORY TREATMENT OF IMPORTS

A. The Philippines' Approach Would Permit Members to Justify Discrimination Based on Price by Citing the Purchasing Patterns Created by the Discrimination

29. One theme of the Philippines is that, notwithstanding that both producers in the Philippines and producers in Members exporting to the Philippines manufacture whiskey and the like, the Philippine market should be divided into different segments based on price, and that as a result Philippine domestic products compete in an entirely different market segment.

30. In one segment, the Philippines would place less expensive brands of distilled spirits, and in the other more expensive spirits. Acceptance of this approach requires treating "sugar based" – to use the Philippines' term – as a proxy for "less expensive."

31. First, such a proxy does not work. Both imported brands and domestic brands are sold at a range of prices, and there are some brands of imported products that cost less than domestic counterparts, such as SKYY vodka and Gilbey's 1857 vodka. Second, there is no need to have a proxy for "less expensive." If the Philippine measures were really about price, it would not need to refer to the raw material used for production. It is only because the Philippine measures sort products by raw material (and discriminates on that basis) that the Philippines takes its approach.

32. This brings to light the fundamental problem with the Philippine market segmentation proposal: it uses the mechanism of discrimination (price) to argue that imported and domestic products do not compete. But the discriminatory impact on price from the discriminatory tax measures *is the problem* that the United States is seeking to address in this dispute.

33. The United States is not suggesting that, but for the excise taxes, imported and domestic products in the Philippines would all be the same price in the Philippines. But by the Philippines' own proposal for segmentation, price affects consumers' purchasing decisions, and the excise taxes are one component of the price of distilled spirits in the Philippines. If the Philippine arguments were accepted, it would mean that a Member could use taxes to make local products relatively cheaper than imported products, and then use the fact that consumers choose local products because of lower cost as the basis to avoid a finding that the taxes discriminate against imported products.

B. Competition between Products Is Not About Income Distribution

34. The Philippines proposes that the income distribution in a Member may affect whether products are "like" or "directly competitive or substitutable." However, this is at odds with the analytic approach taken by panels and the Appellate Body in the past.

35. In particular, each of the factors relied upon by panels and the Appellate Body concern the *goods themselves* – whether physical characteristics, distribution, uses, substitutes, tariff classification and the like. In so far as purchasers are a factor, the emphasis is on the uses to which those goods will be put (that is, whether they are substitutes) and not whether or not consumers can afford a good.

36. Indeed, panels and the Appellate Body have stated clearly that the absence of actual purchases (or even purchases in the near future) does not mean products cannot be substitutes. For example, the Appellate Body in *Korea – Alcohol*, noted the importance of considering latent demand, and whether products *may* be substituted, even if they are not purchased under current conditions. It stated that "the word 'substitutable' indicates that the requisite relationship *may* exist between products that are not, at a given moment, considered by consumers to be substitutes but which are, nonetheless, capable of being substituted for one another."

37. If income distribution could affect whether goods are "substitutable" for the purposes of GATT Article III:2, it would draw emphasis away from the goods themselves and whether they may be substituted, where it belongs, and allow purchasing power or affordability to affect whether such goods are substitutes.

V. ADMINISTRATIVE CHALLENGES DO NOT RELIEVE THE PHILIPPINES OF ITS WTO COMMITMENTS

A. Each WTO Member Takes on the Same Commitments

38. The next theme of the Philippines relates to its capacity as a developing country Member. It cites the administrative difficulties it has faced in collecting taxes as support for two propositions: the Philippines has to rely on indirect taxes such as excise taxes on distilled spirits, and it could not administer another system such as *ad valorem*.

39. As an initial matter, it is unclear what these arguments are intended to demonstrate. The Philippines clarified that it is not raising an Article XX defense. Therefore, the arguments concerning capacity are apparently to assert, in some way, that the Philippine measures are not inconsistent with the GATT 1994 because the Philippines does not have the capacity to manage a different system that would result in progressive taxation.

40. In addition, it is difficult to understand how the Philippines system is "progressive," given that high excise taxes are applied to some products just because of the raw material concerned. As the United States has pointed out, some imported products are relatively less expensive before excise taxes, but when the taxes are added the cost to consumers exceeds that of a local product.

41. Both the United States and the Philippines have cited *Japan – Alcohol* on the issue of a Member's ability to determine its own policy, where the Appellate Body states, "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 [other WTO Agreement commitments]."

42. The Philippines proposes that *Japan – Alcohol* supports the idea that its excise tax regime is within permissible bounds under the WTO, and it is simply its policy choice to meet its fiscal objectives. This interpretation is incorrect. While a Member retains the ability to determine its own tax policy, that discretion is subject to the obligations that the Member has agreed to assume under Article III:2 of the GATT 1994. The Philippine excise tax regime is inconsistent with Article III:2 of GATT 1994. The Philippines is free to pursue indirect, progressive taxation, but it must do so in a way that does not discriminate against imported goods.

B. The Philippines' Current System, Based on Raw Materials, Requires Particular Administrative Burdens

43. Moreover, it is difficult to reconcile some of the Philippines' concerns about capacity for implementation of its tax policy with the description of the way in which its current measures are implemented.

44. In its response to Question 47 from the Panel, the Philippines describes the process by which its tax authorities identify and verify the raw materials used to produce a brand of distilled spirit, as well as determining the net retail price. To verify the raw materials used for a distilled spirit, the Philippines Bureau of Internal Revenue may examine "product literature, brochures and other documentary proof and, if possible, [conduct] laboratory tests of the sample." The Philippine authorities must also verify that the product is produced in a country where the particular raw material is "commercially produced," in order to determine whether the product qualifies for lower tax treatment under Section 141(a). Each of these examinations is necessary only because the Philippines' excise tax system applies different taxes to distilled spirits depending on the raw material. They are extra steps for Philippine administrators that policymakers have elected to maintain.

45. The United States is not taking a position on what measures the Philippines should adopt, so long as those measures are not WTO-inconsistent. At the same time, if the Philippines is arguing that it does not have capacity to operate a different system, it is curious that it would maintain a system which requires such additional steps. And it is also curious that the Philippines purports to operate a "progressive" tax system that differentiates by value, but nonetheless administers it through requirements on raw materials and on commercial production.

VI. THE POSSIBILITY FOR DIFFERENT TREATMENT OF RUM DOES NOT MITIGATE THE WTO-INCONSISTENCY OF THE PHILIPPINE TAX SYSTEM

46. The Philippines has explained that it does not discriminate against rum, and describes how importers may verify that their products are made from local raw materials. It also explains the interpretation of the "commercial production" requirement under which, according to the explanation, the production of the raw materials and the production of the distilled spirit do not need to occur in the same country. If the country where the spirit is distilled also produces the raw material as a general matter, the distilled spirit may qualify for favorable tax treatment.

47. In fact, notwithstanding this possibility, the Philippine measures place additional burdens on, and discriminate against, imports even when made from favored raw materials. For example, the "commercial production" requirement means that a number of countries who produce distilled spirits cannot qualify for favorable tax treatment. Thus, the Philippine measures restrict the scope of imported products that may share the low tax treatment accorded to all Philippine products. The only apparent reason behind such a restriction, which only affects imported products is to help protect domestic production. As the United States explained in its First Written Submission, the Philippine measures are applied "so as to afford protection" to domestic production for the purposes of Article III:2 of GATT 1994 not only because of the sheer magnitude of the difference in taxation between imported and domestic products, but also because of the structure of the measure. As the case of rum bears out, the structure of the measure includes *both* the requirement to use typical local raw materials, and that such materials must be commercially produced in the country where they are processed into distilled spirits.

48. A further evidence of the protectionist nature of the requirement is the fact that there are imported rums that continue to be assigned the higher excise tax rates even though they are made from sugar, such as Malibu rum.

49. In addition, even if some rum products benefit from low tax treatment, that does not mean that the Philippine measures are consistent with its WTO obligations. Imported rums are a tiny segment of the market – overall, rum accounts for approximately 29% of spirits sales in the Philippines, but rum *imports* are only 0.6% of distilled spirits imports. As such, even if some brands of imported rum receive the low tax rate, this would not change the fact that the Philippines' measures subject imported distilled spirits to discriminatory treatment.

VII. THE PHILIPPINES' ADDITIONAL EVIDENTIARY COMPLICATIONS DO NOT CHANGE THE RESULT

50. The Philippines has taken issue with the evidence presented by the United States and the European Union, but its views about what would be the "right" type of evidence do not change the fact that there is ample evidence before the Panel. For example, as noted in Section III above, the Philippines has taken issue with the use of specific examples of brands of gin, vodka, etc., but such examples are particularly relevant by nature of the Philippines measure, in showing that Philippine gins, vodkas, etc. do not look different from imported products.

51. Similarly, the Panel has different sources of information before it on consumer preferences, particularly elasticity of demand in response to changes in price (*e.g.*, Exhibits US-41, PH-49, PH-51). The Philippines' studies are flawed in ways that suggest its results underestimate the substitutability of products (*see*, *e.g.* Exhibit US-48). Nonetheless, the weak results in the Philippines' study reflect substitutability among imported and domestic products; as such this additional source of information merely adds to the record – it does not change the appropriate finding in this dispute.

52. Similarly, the parties have presented different forms of evidence to the Panel in respect of the taxes applied to imported and domestic spirits. Indeed, it is difficult to identify the best way to explain the tax differential between imported and domestic spirits. Because the taxes for products made from non-local products vary by value, and all products are assessed on a proof liter basis, it is necessary to examine individual brands. But, no single brand can stand in for "all imports" or "all domestics." The Philippines' emphasis on averages only serves its argument on market segmentation, and hides the variety – and extremes – of the taxes they impose.

53. None of these differences among parties' presentations affect the appropriate findings in this dispute, however, because the evidence all points in the same direction: higher taxes are imposed on imported products compared to local products. The Panel may review the Philippines' Exhibit PH-19, data on prices and taxation from Exhibit PH-49 or review evidence on how taxes are reflected by prices in stores. In addition, and perhaps most tellingly, the Panel may look directly at the Philippines' own implementing regulations for its measures. The Philippines has compiled detailed annexes to its regulations with information on individual brands sold in the Philippines and the tax applied, which show that the taxes on imported products are higher than the taxes on local products. As the United States observed in that submission, even the lowest per-bottle taxes among the higher-taxed products exceed the taxes on products listed under the "local" annexes in these laws and regulations.

54. In short, the complaints of the Philippines about the kind of evidence provided by the complainants do not change the fact that the evidence plainly shows that the Philippines' excise taxes on distilled spirits are inconsistent with Article III:2 of the GATT 1994.

VIII. CONCLUSION

55. This dispute does not present novel legal issues, nor does it involve a particularly complicated set of facts. The Philippines applies tax rates to spirits not produced from local-type materials far in excess of those applied to "like" local distilled spirits – from ten to 40 times higher. These Philippines and imported spirits are also "directly competitive and substitutable," and the Philippines imposes the differential tax in order to protect domestic production. Accordingly, the United States respectfully requests that the Panel find that the Philippines measures are inconsistent with the first and second sentences of Article III:2 of the GATT 1994.