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# *Still Hazy after All These Years: The Interpretation of National Treatment in the GATT/WTO Case-law on Tax Discrimination*

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## **Abstract**

*This article discusses the National Treatment (NT) obligation as applied in the GATT tax discrimination cases. The central thesis of the paper is that case-law has not clarified the interpretation of the terms in Article III. It appears that the reason for this failure is the lack of a conceptually coherent view of the role of the NT obligation. After summarizing the case-law on discriminatory taxation, this article lays out a theory of the role of NT in trade agreements, in order to shed light on appropriate interpretations of the terms appearing in Article III. We start from the notion that the GATT is an obligationally incomplete contract. This incompleteness invites beggar-thy-neighbour type behaviour, and the NT obligation is an imperfect remedy for such problems. We suggest that likeness/directly competitive or substitutable (DCS) should be determined 'in the market place', whereas the 'so as to afford protection' criterion is ultimately about the protection of expectations concerning the intent behind domestic regulations. But since intent usually cannot be determined directly, adjudicating bodies have to seek recourse to indirect evidence, as is frequently done in legal practice.*

## **1 Introduction**

In the policy debate on the virtues and vices of the World Trade Organization (WTO), two very different perspectives are pitted against each other: on one side the

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traditional view, cherished by economists and many policy-makers, who see the WTO essentially as a vehicle to reduce border measures, such as through tariffs, quotas, and export subsidies. While acknowledging that this liberalization may have negative effects on certain income groups, most who see the WTO from this perspective would argue that it yields aggregate gains. On the other side are those who see the WTO as being about much more than a reduction of border measures; the WTO is instead seen as imposing considerable constraints on national governments' sovereignty, by restricting their ability to freely determine, for instance, domestic regulations affecting health and the environment. These constraints are often claimed to be so costly that they dominate any gains from the liberalization of border measures, to the extent that the latter exist at all.

The economic literature on trade agreements does not give much support to the latter point of view: with few exceptions it views trade agreements essentially as agreements on reductions of tariffs, possibly complemented with rules for renegotiation of bindings, and for the resolution of trade disputes. Nevertheless, it is clear that the WTO is about more than reductions of border measures. It is a basic undertaking by WTO Members *not to use internal policy measures in a protectionist fashion*. This obligation is enshrined in the National Treatment (NT) provision found in several of the WTO Agreements.

The potential reach of the WTO NT provisions is hard to overestimate: they cover virtually *all* governmental policies of all the currently 146 Members of the WTO, whether be they taxes, laws, regulations, etc., which affect the conditions for sale and distribution, widely interpreted, of imported products and services. In addition, NT provisions cover not only explicitly discriminatory internal measures, but also policies that indirectly have such consequences.

There is thus no doubt that the critique of the WTO is potentially correct, in the sense that the NT obligation may (depending on its interpretation) have a profound impact on countries' freedom to choose domestic policies. The interpretation of NT is thus of central importance. Still, the economic literature has devoted hardly any attention to this issue, to the best of our knowledge, while legal literature has yet to look at this issue in a systematic manner. The purpose of this paper is to initiate such an investigation. The focus will be on the impact of NT on internal taxation, taxes being the natural counterpart to tariffs, and thus a natural starting point for an analysis of NT.

There has recently been a number of disputes in which Article III.2 GATT has been invoked to address alleged discriminatory taxation.<sup>1</sup> Panels and the Appellate Body (AB) have in these disputes interpreted central concepts of the WTO contract. This article aims to examine these interpretations from a joint economic and legal perspective.

The passages in Article III of immediate relevance to discriminatory taxation are the following. Article III.2, first sentence:

<sup>1</sup> Throughout this article we will use 'Article III' to refer to 'Article III GATT'.

The products of the territory of any contracting party imported into the territory of any other contracting party 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.

Article III.2, second sentence:

Moreover, no contracting party 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.

where the paragraph referred to (Article III.1) reads

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.

Finally, Article III.2, second sentence, has an Interpretative Note that reads:

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.

A complaining party alleging a violation of Article III.2 thus has two possible routes.<sup>2</sup> One is to argue that: (i) the domestic and the foreign products are *like*; and (ii) the latter is taxed *in excess* of the former. The other is to claim that: (iii) the two products are directly competitive or substitutable (DCS); (iv) the two products are *not similarly taxed*; (v) the dissimilar taxation operates *so as to afford protection* (SATAP) to domestic production.<sup>3</sup>

Central to the scope of the NT provision is thus the adjudicating bodies' interpretation of the italicized terms in (i)-(v). Most of the discussion here will focus on interpretations of these terms.

Three disputes are of particular interest with regard to the case-law, all of them involving taxation of alcohol: *Japan — Taxes on Alcoholic Beverages*,<sup>4</sup> *Korea — Taxes on Alcoholic Beverages*,<sup>5</sup> and *Chile — Taxes On Alcoholic Beverages*.<sup>6</sup> To the extent relevant, other disputes will be reflected.

In *Japan*, the Panel and the AB were confronted with a Japanese law taxing the locally produced alcoholic beverage *sochu* more favourably than a series of western

<sup>2</sup> According to case-law, in the WTO it is the party that makes a claim/argument that carries the burden of proof to show that the claim/argument at hand holds.

<sup>3</sup> It could be argued that a textual reading of the Interpretative Note ad Article III suggests that points (iv) and (v) are one and the same. As we will explain *infra*, the AB has distinguished between the two elements in the sense that, in its view, dissimilar taxation is a necessary but not sufficient condition for protection to have been afforded.

<sup>4</sup> WTO Doc. WT/DS8, 10, 11/AB/R of 4 October 1996 [hereinafter *Japan*].

<sup>5</sup> WTO Doc. WT/DS 75, 84/AB/R of 18 January 1999 [hereinafter *Korea*].

<sup>6</sup> WTO Doc. WT/DS87, 110/AB/R of 13 December 1999 [hereinafter *Chile*]. A comprehensive discussion of all the GATT/WTO case-law in this respect may be found in C. Dordi, *La discriminazione commerciale nel diritto internazionale* (2002).

drinks. Japan argued that the *sochu* was not in a ‘like’ or DCS relationship to the imported beverages, and that Article III thus did not apply.

In *Korea*, Korea was alleged to violate Article III.2, by taxing a number of distilled alcoholic beverages predominantly produced in the European Community (EC) and the United States (US), in excess of *soju*, a beverage predominantly produced in Korea, and in particular in excess of diluted *soju*. Korea argued that the case mainly concerned the diluted *soju*, which accounted for 99 per cent of sales of *soju*, that this product was an unlike product to distilled *soju*, and that the diluted *soju* was not even in a DCS relationship to imported liquors. Korea did not offer an alternative policy explanation, such as health.

*Chile* addressed discriminatory taxation of alcohol, this time in favour of the Chilean *pisco*. *Chile* contributed to the understanding of the SATAP concept. There has been no jurisprudential development in the field of tax discrimination post-*Chile*.

All three cases involved instances of alleged *de facto* discrimination, that is, the favourable discriminatory treatment of the domestic products was not explicitly based on their origin but was applied to *soju*, *sochu* and *pisco* in general, irrespective of origin. Since most *sochu* is produced in Japan, most *soju* in Korea, and most *pisco* in Chile, it was alleged by the complainants that the taxation systems in Japan and Korea, respectively, ended up conferring an advantage on the predominantly national products.

In *Japan*, the Panel and the AB found that all pairs of the products concerned were DCS and one pair (vodka and *sochu*) were like products. They further found that Japan’s practices were in violation of Article III.2. In *Korea*, the Panel and the AB concurred that the Korean laws were indeed in violation of Article III.2, by imposing heavier taxation on western drinks than that imposed on *soju*, since the various products concerned were found to be DCS. *Chile* followed a similar route since the products concerned were found to be DCS and the differential taxation operated in favour of domestic products.

Sections 2 and 3 present the case-law on the key terms of Article III (‘like’, ‘DCS’ and ‘SATAP’). In Section 4 we summarize our understanding of the case-law. Section 5 suggests a possible, and to our mind plausible, rationale for an NT provision in a trade agreement. An important purpose of the GATT is to help its Members achieve economic benefits from trade liberalization. We will therefore establish the role of NT in the exploitation of such gains, whether seen as stemming from improved market access or exploitation of comparative advantages, before turning to an evaluation of the case-law. The need to take this step is obvious from an economic point of view, since the terms in Article III, such as ‘like products’, have no context-independent, ‘true’ economic meaning, but must be interpreted in light of the intention of the regulation. The notion that individual provisions of the WTO Agreement must be interpreted in their context and in accordance with the object and purpose of the Agreement where they belong also finds support in legal theory: when interpreting a provision of the WTO contract, WTO adjudicating bodies, in accordance with Article 3.2 DSU, must observe customary rules of interpretation of international treaties. The

interpreter has to see terms in their context,<sup>7</sup> that is, within the legal instrument to which they belong.<sup>8</sup> This discussion serves as the theoretical benchmark to critically evaluate the case-law of the WTO adjudicating bodies (Section 6). In Section 7 we recapitulate our main conclusion of the paper, which is that the WTO adjudicating bodies (and for all practical purposes, the AB) have no clear methodology to offer for interpreting the NT obligation enshrined in Article III.2. The ambit of NT post-interpretation is still hazy after all these years.<sup>9</sup>

## 2 The Case-law on ‘Like’ and ‘DCS’ Products

### A The Interpretation of Like/DCS in the GATT Era

Up to and including the 1987 dispute between the European Community and Japan concerning Japanese taxation of alcoholic beverages,<sup>10</sup> likeness was seen as determined by consumer behaviour. The 1992 *Malt Beverages*<sup>11</sup> report laid down the groundwork, to some extent, for the 1994 *Gas Guzzler* report, which, however, took a

<sup>7</sup> Jimenez de Arechaga observed that ‘it is important to remark that “the object and purpose of the treaty” is mentioned not as an independent element as in the Harvard Draft Convention but at the end of paragraph 1. This was done deliberately, in order to make clear that “object and purpose” are part of the context, the most important one, but not an autonomous element in interpretation, independent of and on the same level as the text, as is advocated by the partisans of the teleological method of interpretation’, see de Arechaga, ‘International Law in the Past Third of the Century’, 159 *RdC.* (1978, I) 42 *et seq.* reprinted in L. Damrosch, *et al.*, *International Law, Cases and Materials* (4th ed., 2001), at 509. A contextual interpretation, while keeping the object and purpose of the agreement *on screen*, focuses on the means at the disposal of the international regime as well. Thus, the interpreter does not run the risk of having recourse to pure teleological approaches and presume transfer of sovereignty where it does not exist. This would be the inevitable outcome were the interpreter not to pay sufficient attention to the means at the disposal of the ends assigned into the international regime.

<sup>8</sup> Art. 3.2 DSU reads: ‘The dispute settlement of the WTO is a central element in providing security and predictability to the multilateral trading system. The Members recognize that it serves to preserve the rights and obligations of Members under the covered agreements, and to clarify the existing provisions of those agreements in accordance with customary rules of interpretation of public international law. Recommendations and rulings of the DSB cannot add to or diminish the rights and obligations provided in the covered agreements.’ See, on this issue, the AB report on *United States — Standards for Reformulated and Conventional Gasoline*, WTO Doc. WT/DS2/AB/R of 29 April 1996. See also the recent AB report *United States — Definitive Safeguard Measures on Imports of Circular Welded Carbon Quality Line Pipe from Korea*, WTO Doc. WT/DS202/AB/R, at para. 165.

<sup>9</sup> Concrete proposals toward understanding NT are put forward in the GATT context by Howse and Reagan, ‘The Product/Process Distinction — An Illusory Basis for Disciplining “Unilateralism” in Trade Policy’, 11 *EJIL* (2000) 249 and Hudec, ‘GATT/WTO Constraints on National Regulation: Requiem for an “Aims and Effect” Test’, 32 *International Lawyer* (1998) 619, and, in the GATS context by Mattoo, ‘MFN and the GATS’, in T. Cottier and P. C. Mavroidis (eds), *Regulatory Barriers and the Principle of Non-Discrimination in World Trade Law* (2000) 51.

<sup>10</sup> It is by now standing WTO case-law that adopted GATT panel reports are decisions in the sense of Art. XVI of the Agreement Establishing the WTO and as such provide useful guidance to future WTO panels dealing with the same issue. Moreover, WTO panels have also looked into interpretations of the GATT as proposed in GATT unadopted panel reports when they found that their reasoning was persuasive.

<sup>11</sup> DS23/R, adopted on 19 June 1992, GATT Doc. BISD 39S/206.

markedly different approach.<sup>12</sup> It proposed that likeness between two products should be evaluated in light of the aim and effect of the challenged regulatory intervention that gave rise to the dispute in the first place. First, the Panel asks how likeness should be appreciated:

Thus the practical interpretative issue under paragraphs 2 and 4 of Article III was: which differences between products may form the basis of regulatory distinctions by governments that accord less favourable treatment to imported products? Or, conversely, which similarities between products prevent regulatory distinctions by governments that accord less favourable treatment to imported products?<sup>13</sup>

The Panel then provides the legal forum within which it will entertain the question asked:

In order to determine this issue, the Panel examined the object and purpose of paragraphs 2 and 4 of Article III in the context of the article as a whole and the General Agreement.<sup>14</sup>

And it finally provides its understanding on the issue:

The Panel then proceeded to examine more closely the meaning of the phrase ‘so as to afford protection.’ The Panel noted that the term ‘so as to’ suggested both aim and effect. Thus the phrase ‘so as to afford protection’ called for an analysis of elements including the aim of the measure and the resulting effects. A measure could be said to have the *aim* of affording protection if an analysis of the circumstances in which it was adopted, in particular an analysis of the instruments available to the contracting party to achieve the declared domestic policy goal, demonstrated that a change in competitive opportunities in favour of domestic products was a desired outcome and not merely an incidental consequence of the pursuit of a legitimate policy goal. A measure could be said to have the *effect* of affording protection to domestic production if it accorded greater competitive opportunities to domestic products than to imported products. The effect of a measure in terms of trade flows was not relevant for the purposes of Article III, since a change in the volume or proportion of imports could be due to many factors other than government measures.<sup>15</sup>

According to this view, likeness will not be defined by reference to prevailing perceptions about the pair of products in the marketplace, but by reference to the regulatory aims pursued by the intervening government. The second leg of this test (the ‘effects’ test) becomes meaningless since no effects-analysis is needed in light of prior case-law which suggests that Article III exists to protect competitive opportunities.<sup>16</sup>

This was the last case adjudicated in the context of Article III in the GATT era.

## **B The WTO Case-law on DCS Products**

We start with the DCS category. Having found that the products concerned were DCS and having established a violation of Article III.2, second sentence, the Panel and the AB in *Korea* did not consider it necessary to establish a violation of Article III.2,

<sup>12</sup> *United States — Taxes on Automobiles*, GATT Doc. DS31/R of 11 October 1994, often quoted as the *Gas Guzzler* dispute.

<sup>13</sup> *Ibid.*, at para. 5.6.

<sup>14</sup> *Ibid.*, at para. 5.7.

<sup>15</sup> *Ibid.*, at para. 5.10 (emphasis in original).

<sup>16</sup> See *infra* Section 3C.

first sentence as well. *Korea* held for the proposition that like products are a *sub-set* of DCS products, so that if two products are like, they are *per se* DCS. In this respect, the report pertinently reads:

'Like' products are a subset of directly competitive or substitutable products: all like products are, by definition, directly competitive or substitutable products, whereas not all 'directly competitive or substitutable' products are 'like'.<sup>17</sup>

Hence, all of the case-law on Article III.2, second sentence (which deals with DCS products) is *ipso facto* relevant for the interpretation of the term 'like' products.

We now turn to the AB's understanding of the term 'DCS products' as reflected in *Japan*:

(a) 'Directly Competitive or Substitutable Products'

In this case, the Panel emphasized the need to look not only at such matters as *physical characteristics, common end-uses, and tariff classifications, but also at the 'market place'*. *This seems appropriate*. The GATT 1994 is a commercial agreement, and the WTO is concerned, after all, with markets. It does not seem inappropriate to look at competition in the relevant markets as one among a number of means of identifying the broader category of products that might be described as 'directly competitive or substitutable'.

*Nor does it seem inappropriate to examine elasticity of substitution as one means of examining those relevant markets*. The Panel did not say that cross-price elasticity of demand is 'the decisive criterion' (footnote omitted) for determining whether products are directly competitive or substitutable. The Panel stated the following:

In the Panel's view, the decisive criterion in order to determine whether two products are directly competitive or substitutable is whether they have common end-uses, inter alia, as shown by elasticity of substitution.

We agree. And, we find the Panel's legal analysis of whether the products are 'directly competitive or substitutable products' in paragraphs 6.28–6.32 of the Panel Report to be correct.<sup>18</sup>

*Korea* understands DCS products as follows:

A. 'Directly Competitive or Substitutable Products'

...

1. Potential Competition

...

... In our view, 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. ...

2. Expectations

...

As we have said, the object and purpose of Article III is the maintenance of equality of competitive conditions for imported and domestic products (footnote omitted) ...

3. 'Trade Effects' Test

...

... the Panel stated that if a particular degree of competition had to be shown in quantitative terms, that would be similar to requiring proof that a tax measure has a particular impact on trade. **It considered such an approach akin to a 'type of trade effects test'**.

<sup>17</sup> *Korea*, at para. 118.

<sup>18</sup> *Japan*, at 25 (emphasis added).

We do not consider the Panel's reasoning on this point to be flawed.

#### 4. Nature of Competition

...

The Panel considered that in analyzing whether products are 'directly competitive or substitutable', the focus should be on the nature of competition and not on its quantity ... For the reasons set above, **we share the Panel's reluctance to rely unduly on quantitative analyses of the competitive relationship.** (footnote omitted) **In our view, an approach that focused solely on the quantitative overlap of competition would, in essence, make cross-price elasticity the decisive criterion in determining whether products are 'directly competitive or substitutable'.** We do not, therefore, consider that the Panel's use of the term 'nature of competition' is questionable.

#### 5. Evidence from the Japanese Market

... **It seems to us that evidence from other markets may be pertinent to the examination of the market at issue, particularly when demand on that market has been influenced by regulatory barriers to trade or to competition.** Clearly, not every other market will be relevant to the market at issue. But if another market displays characteristics similar to the market at issue, then evidence of consumer demand in that other market may have some relevance to the market at issue. This, however, can only be determined on a case-by-case basis, taking account of all relevant facts.<sup>19</sup>

Chile did not add anything or detract from the definition of DCS products.

### C *The WTO Case-law on Likeness*

In *Japan*, the Appellate Body ruled that the term 'like products' invites a narrow reading and that customs classification is relevant to establish likeness, beyond the criteria traditionally used to establish a DCS relationship:

#### (a) 'Like Products'

Because the second sentence of Article III:2 provides for a separate and distinctive consideration of the protective aspect of a measure in examining its application to a broader category of products that are not 'like products' as contemplated by the first sentence, we agree with the Panel that the first sentence of Article III:2 must be construed narrowly so as not to condemn measures that its strict terms are not meant to condemn...

The concept of 'likeness' is a relative one that evokes the image of an accordion. The accordion of 'likeness' stretches and squeezes in different places as different provisions of the WTO Agreement are applied. The width of the accordion in any one of those places must be determined by the particular provision in which the term 'like' is encountered as well as by the context and the circumstances that prevail in any given case to which that provision may apply. We believe that, in Article III:2, first sentence of the GATT 1994, the accordion of 'likeness' is meant to be narrowly squeezed.<sup>20</sup>

The Appellate Body confirmed that customs classification is an appropriate criterion to define likeness:

If sufficiently detailed, tariff classification can be a helpful sign of product similarity.<sup>21</sup>

Not just any customs classification, however, can help define likeness. A necessary condition is that the classification at hand is precise. We read in the same report:

<sup>19</sup> *Korea*, at paras 114, 125–127, 130–131, 133–134, 135–138 (italics in original, bold emphasis added).

<sup>20</sup> *Japan*, at 19–21.

<sup>21</sup> *Ibid.*, at 23.



It is true that there are numerous tariff bindings which are in fact extremely precise with regard to product description and which, therefore, can provide significant guidance as to the identification of 'like products'.<sup>22</sup>

### 3 The Case-law on 'So as to Afford Protection'

#### A *The Relationship between Article III.1 and Article III.2*

Article III.1 is expressed in a manner that resembles a 'best endeavours clause', while Article III.2 is expressed in precise, binding legal terms. The relationship between these paragraphs — how much of Article III.1 we should see in Article III.2 — is of relevance for the understanding of the terms figuring in Article III.2.

The AB addressed the relationship between Article III.1 and Article III.2, first sentence, in the *Japan* report in the following manner:

Article III:1 informs Article III:2, first sentence, by establishing that if imported products are taxed in excess of like domestic products, then that tax measure is inconsistent with Article III. Article III:2, first sentence does not refer specifically to Article III:1. There is no specific invocation in this first sentence of the general principle in Article III:1 that admonishes Members of the WTO not to apply measures so as to afford protection. This omission must have some meaning. We believe the meaning is simply that the presence of a protective application need not be established separately from the specific requirements that are included in the first sentence in order to show that a tax measure is inconsistent with the general principle set out in the first sentence. However, this does not mean that the general principle of Article III:1 does not apply to this sentence. To the contrary, we believe the first sentence of Article III:2 is, in effect, an application of this general principle. The ordinary meaning of the words of Article III:2, first sentence leads inevitably to this conclusion. Read in their context and in the light of the overall object and purpose of the *WTO Agreement*, the words of the first sentence require an examination of the conformity of an internal tax measure with Article III by determining, first, whether the taxed imported and domestic products are 'like' and, second, whether the taxes applied to the imported products are 'in excess of' those applied to the like domestic products. If the imported and domestic products are 'like products', and if the taxes applied to the imported products are 'in excess of' those applied to the like domestic products, then the measure is inconsistent with Article III:2, first sentence.<sup>23</sup>

With regard to DCS products, the same report rejects a similar reading, however:

Unlike that of Article III:2, first sentence, the language of Article III:2, second sentence, specifically invokes Article III:1. The significance of this distinction lies in the fact that whereas Article III:1 acts implicitly in addressing the two issues that must be considered in applying the first sentence, it acts explicitly as an entirely separate issue that must be addressed along with two other issues that are raised in applying the second sentence. Giving full meaning to the text and to its context, three separate issues must be addressed to determine whether an internal tax measure is inconsistent with Article III:2, second sentence. These three issues are whether:

- (1) the imported products and the domestic products are '*directly competitive or substitutable products*' which are in competition with each other;
- (2) the directly competitive or substitutable imported and domestic products are '*not similarly*

<sup>22</sup> *Ibid.*, at 24.

<sup>23</sup> *Ibid.*, at 18–19 (emphasis in original).

*taxed*’; and

(3) the dissimilar taxation of the directly competitive or substitutable imported domestic products is ‘*applied ... so as to afford protection to domestic production*’.<sup>24</sup>

Hence, in the AB’s view, Article III.1 is relevant for the whole of Article III.2. But with respect to like products, taxation in excess of the domestic like product *ipso facto* amounts to a violation of the SATAP requirement, whereas in the case of DCS products, a separate finding that the SATAP requirement has been violated is necessary.<sup>25</sup>

### **B Article III.2 Is Not about Protective Intent**

In *Japan* the AB accepts the relevance of Article III.1 when interpreting the terms in Article III.2, but rejects the idea that intent is relevant for the purposes of interpreting the SATAP requirement:

(c) ‘So As to Afford Protection’

This third inquiry under Article III:2, second sentence, must determine whether ‘directly competitive or substitutable products’ are ‘not similarly taxed’ in a way that affords protection. This is not an issue of intent. It is not necessary for a panel to sort through the many reasons legislators and regulators often have for what they do and weigh the relative significance of those reasons to establish legislative or regulatory intent. **If the measure is applied to imported or domestic products so as to afford protection to domestic production, then it does not matter that there may not have been any desire to engage in protectionism in the minds of the legislators or the regulators who imposed the measure.** It is irrelevant that protectionism was not an intended objective if the particular tax measure in question is nevertheless, to echo Article III:1, ‘*applied to imported or domestic products so as to afford protection to domestic production*’. This is an issue of how the measure in question is *applied*.<sup>26</sup>

In *Korea*, the AB opined that the protective application of the measure can be discerned from the legislation even if no full intent test is warranted under Article III.2:

Although it is true that the aim of a measure may not be easily ascertained, nevertheless its protective application can most often be discerned from the design, the architecture, and the revealing structure of a measure. The very magnitude of the dissimilar taxation in a particular case may be evidence of such protective application . . . Most often, there will be other factors to be considered as well.<sup>27</sup>

In *Chile*, the AB was faced with the following facts: the Chilean law distinguished between three categories of alcoholic beverages: drinks below 35° alcoholic content; drinks between 35° and 39°; and finally drinks with alcoholic content of more than 39°. The products of the first category were taxed at 27 per cent *ad valorem*, whereas the products of the last category were taxed at 47 per cent *ad valorem*. The

<sup>24</sup> *Ibid.*, at 27 (emphasis in original).

<sup>25</sup> It can be noted that the *Japan* Panel held the view that the Interpretative Note to Art. III.2 GATT explains when discriminatory taxation operates SATAP and thus the satisfaction of the criteria laid down in the Interpretative Note makes the additional reference to Art. III.1 GATT superfluous. This view was not adopted by the AB in its *Japan* report, however.

<sup>26</sup> *Japan*, at 27–30 (italics in original, bold emphasis added).

<sup>27</sup> *Korea*, at para. 150.

complaining parties argued that some western products of slightly more than 39° were DCS products to Chilean products of less than 35° and that the tax differential operated SATAP. Chile responded that in the over 39° tax category, the majority of the products hit by high taxation were domestic and that no protection could hence result from such a taxation scheme.<sup>28</sup> The AB agreed that as a matter of fact most of the alcoholic drinks hit by the higher taxation were of Chilean origin. However, it dismissed the relevance of this observation for the interpretation of the SATAP requirement in the following terms:

This fact does not, however, by itself outweigh the other relevant factors, which tend to reveal the protective application of the New Chilean System. The relative proportion of domestic versus imported products within a particular fiscal category is not, in and of itself, decisive of the appropriate characterization of the total impact of the New Chilean system under Article III:2, second sentence, of the GATT 1994. This provision, as noted earlier, provides for equality of competitive conditions of *all* directly competitive or substitutable imported products, in relation to domestic products, and not simply, as Chile argues, those imported products within a particular fiscal category. The cumulative consequence of the New Chilean System is, as the Panel found, that approximately 75 percent of all domestic production of the distilled alcoholic beverages at issue will be located in the fiscal category with the lowest tax rate, whereas approximately 95 percent of the directly competitive or substitutable imported products will be found in the fiscal category subject to the highest tax rate.<sup>29</sup>

In *Chile*, the AB did try to bring an *intent*-based test within the analysis of the SATAP criterion. As was the case previously in *Japan* and *Korea*, however, the AB made it clear that it used this test to denote *protective application* of the legislation and did not move to a pure *intent*-based test. The report pertinently reads in this respect:

The subjective intentions inhabiting the minds of individual legislators or regulators do not bear upon the inquiry, if only because they are not accessible to treaty interpreters. It does not follow, however, that the statutory purposes or objectives — that is, the purpose or objectives of a Member's legislature and government as a whole — to the extent that they are given objective expression in the statute itself, are not pertinent. To the contrary, as we also stated in *Japan — Alcoholic Beverages*:

'Although it is true that the aim of a measure may not be easily ascertained, nevertheless its *protective application* can most often be discerned from the *design*, the *architecture*, and the revealing *structure* of a measure.'<sup>30</sup>

The AB then stated:

Before the Panel, Chile stated that the New Chilean System pursued four different objectives: '(1) maintaining revenue collection; (2) eliminating type distinctions [such] as [those which] were found in Japan and Korea; (3) discouraging alcohol consumption; and (4) minimizing the potentially regressive aspects of the reform of the tax system.'<sup>31</sup>

And finally the AB went on to conclude that:

Chile's explanations concerning the structure of the New Chilean System — including, in particular, the truncated nature of the line of progression of tax rates, which effectively consists

<sup>28</sup> *Chile*, at para. 58.

<sup>29</sup> *Ibid.*, at para. 67 (emphasis in original).

<sup>30</sup> *Ibid.*, at para. 62 (emphasis added).

<sup>31</sup> *Ibid.*, at para. 69.

of two levels (27 per cent *ad valorem* and 47 per cent *ad valorem*) separated by only 4 degrees of alcohol content — might have been helpful in understanding what *prima facie* appear to be anomalies in the progression of tax rates. The conclusion of protective application reached by the Panel becomes very difficult to resist, in the absence of countervailing explanations by Chile.<sup>32</sup>

### C Article III.2 is not about Effects in the Market Either

As briefly touched upon in Section 2A above, GATT case-law has made clear (the *Superfund* jurisprudence) that the legal test for consistency of a measure with Article III does not extend to a review of the effects of the measure in the market. Article III is there to protect expectations about a behaviour and trade effects are, consequently, irrelevant.<sup>33</sup>

According to the *Superfund* ruling:

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. A change in the competitive relationship contrary to that provision must consequently be regarded *ipso facto* as a nullification or impairment of benefits accruing under the General Agreement. 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 that provision had not been nullified or impaired even if such a rebuttal were in principle permitted.<sup>34</sup>

Protection in the sense of Article III in GATT/WTO jurisprudence is hence not linked to a specific market outcome but to an abstract notion of *lack of regulatory neutrality*.

### D Tax Differentials Indicating Measures that Operate SATAP

#### 1 Tax Differentials Applied on Like Products

The AB has refrained from providing a general definition of protection, but has instead given judgment on whether specific instances of discriminatory taxation are sufficiently pronounced to satisfy the SATAP requirement.

The AB has further argued that a proper reading of Article III.2 leads to the conclusion that a measure affords protection in significantly different ways depending on whether the products involved are like or DCS: with like products, a measure operates SATAP *any time* the foreign product is taxed in excess of the domestic like product. In *Japan*, the AB report reads:

(b) 'In Excess Of'

Even the smallest amount of 'excess' is too much. 'The prohibition of discriminatory taxes in Article III:2, first sentence, is not conditional on a 'trade effects test' nor is it qualified by a *de minimis* standard'.<sup>35</sup>

Hence, even a minimal difference suffices for the in excess-criterion to be satisfied.

<sup>32</sup> *Ibid.*, at para. 72 (emphasis in original).

<sup>33</sup> We discuss this issue in more detail in Section 5B1.

<sup>34</sup> *United States — Taxes on Petroleum and Certain Imported Substances*, Report of the Panel adopted on 17 June 1987, L/6175, GATT Doc. BISD 34S/136, at para. 5.1.9 (underlining in original, italic emphasis added).

<sup>35</sup> *Japan*, at 23.

## 2 Tax Differentials Applied on DCS Products

Japan states:

(b) 'Not Similarly Taxed'

...

... The dissimilar taxation must be more than *de minimis*. It may be so much more that it will be clear from that very differential that the dissimilar taxation was applied 'so as to afford protection'. In some cases, that may be enough to show a violation. In this case, the Panel concluded that it was enough. Yet in other cases, **there may be other factors that will be just as relevant or more relevant to demonstrating that the dissimilar taxation at issue was applied 'so as to afford protection'**.<sup>36</sup>

In *Korea*, the AB reproduced these conclusions. In *Chile*, the two categories of alcoholic beverages (below 35° and above 39°) were DCS products, and the tax differential (27 per cent and 47 per cent, respectively) was more than *de minimis*. The AB condemned the Chilean fiscal scheme,<sup>37</sup> in line with its verdict in *Japan*.

To conclude, in the case of DCS products, the magnitude of the tax differential imposed on a pair of DCS products sometimes by itself (when the tax differential is substantially more than *de minimis*, as was the case in all three disputes presented here) and sometimes in conjunction with other factors, such as the 'design', the 'architecture' and the 'revealing structure' of the measure (when the tax differential is more than *de minimis* but not substantially more) will establish a violation of the SATAP requirement.

The AB has defined neither the term '*de minimis*' nor the term 'magnitude of dissimilar taxation', and it is left to the discretion of WTO adjudicating bodies to decide on a case-by-case basis.

## 4 The Current Interpretation of the Terms in Article III.2 in a Nutshell

Post-*Chile*, we can summarize the WTO case-law as follows:

- (i) The *raison d'être* of Article III is to protect the value of concessions negotiated in the GATT/WTO rounds (so that Members will have an incentive to further exchange concessions and hence liberalize trade).
- (ii) Article III protects competitive opportunities and, as a result, trade effects are not an issue when discussing an alleged violation of Article III.
- (iii) The legal test for demonstrating conformity (or lack of it) of a domestic taxation scheme with Article III.2 is clear: with respect to Article III.2, first sentence, the satisfaction of the likeness and taxation in excess criteria *ipso facto* amounts to a

<sup>36</sup> *Ibid.*, at 26 and 30.

<sup>37</sup> *Chile*, at paras 44–55.

violation of Article III.1 (two-prong test). When it comes to Article III.2, second sentence, the complainant must show, beyond a DCS relationship between two products and a tax differential, that the latter operates SATAP (three-prong test). In this case, sometimes a more than *de minimis* tax differential will suffice to satisfy the SATAP criterion, and sometimes recourse will be made to other factors indicating the protective application of the measure at hand. The AB has provided an indicative list of such factors but has yet to explain which cases fall under the first and which under the second category.

- (iv) Article III.2 covers cases of both *de jure* and *de facto* discrimination.
- (v) According to the AB, intent is immaterial when interpreting Article III since it is the *protective application* of domestic legislation that matters.
- (vi) To establish whether two products are DCS, WTO adjudicating bodies could look at factors like cross-price elasticity, elasticity of substitution, end-uses, consumers' tastes and habits, and the products' properties and nature. The list of relevant criteria is not exhaustive; WTO adjudicating bodies might add other factors to the list. The AB has not clarified the weight to be given to each of the mentioned elements, but it stated that cross-price elasticity is not the decisive criterion. Potential competition is relevant to establish the DCS relationship, especially in cases of 'latent demand'. Evidence from other markets concerning the DCS relationship between two products is welcome at least in cases where a potentially DCS product has not made its way into a particular market as a result of a regulatory intervention. The AB has not offered any precise criteria as to the appropriateness of comparability between two markets.
- (vii) To establish likeness, a complainant needs to show, besides what is needed to establish a DCS relationship, additional factors that might argue in favour of likeness. The only such factor mentioned in case-law so far is tariff classification. However, the description in tariff classification must be quite comprehensive. Generally speaking, there is a tendency in case-law to construe like products in a narrow manner.
- (viii) All like products are, by definition, DCS products. Hence, the complainant who succeeds in showing that two products are like has, by definition, also shown that the two products are DCS.
- (ix) Finally, an observation which does not stem directly from the discussion so far may be made. It is by now settled case-law that a WTO Member whose practices are found to be in violation of Article III can still justify these through recourse to Article XX. Violation of Article III does not *ipso facto* amount to violation of the GATT. Article XX can 'heal' the violation of Article III and intent is relevant in the context of Article XX. In other words, what the AB has done in the tax discrimination cases that it has treated so far is to provide a 'dividing line' between Article III and Article XX: the applicability of Article III is determined in the market place, whereas an evaluation under Article XX may involve other considerations (the *Japan* panel report reflects similar thoughts which were not overturned by the AB).

## 5 A Theoretical Rationale for an NT Provision

Our aim in this Section is to contribute to an understanding of how Article III 'should' be interpreted. To achieve this, we start by presenting a general economic perspective on the rationale of NT provisions in trade agreements. Drawing on the implications of this analysis, Section 6 discusses the text and case-law of Article III.2 GATT, with particular emphasis on the interpretation of the terms like/DCS and SATAP.

A fundamental feature of trade policy instruments is that they tend to give rise to Prisoners' Dilemma problems. For instance, governments may have unilateral incentives to impose tariffs or import quotas, even if trading partners pursue liberal tariff policies. A basic economic rationale for trade agreements is to help governments move at least partially away from this type of situation, through mutually beneficial reciprocal reductions in trade barriers.<sup>38</sup>

Domestic policy measures may be associated with very similar types of problems as border measures. Virtually *every* internal policy measure will affect trade. Sometimes the effect is rather direct, as in the case of a specific sales tax for imports. But typically, the effects are more indirect. For instance, the level of income taxation may affect labour supply, and thus wages. This will in turn influence firms' production decisions and consumers' consumption decisions, and thereby trade. Of course, these effects are in practice mostly unintended and negligible, and are sometimes beneficial to other countries. However, countries may also knowingly pursue internal policies with a significant detrimental impact on other countries in order to promote their own interests.

The Prisoners' Dilemma problem with regard to internal measures can under certain special circumstances be avoided. If the parties to the trade agreement could perfectly foresee the future and all the different ways in which domestic policy measures might be used to undo agreed reductions of trade policy instruments, they can specify how all the relevant domestic *policies* are to be set along this path. With this information, they could alternatively agree directly on *outcomes* in terms of trade flows. Countries could then pursue whatever internal policies they want, as long as they 'delivered' the trade flows stipulated in the agreement. Both types of contracts could in principle be designed so as to allow specialization across countries according to comparative advantages, to the extent that governments so desired.

A third possibility, in the event that parties cannot foresee exactly how the external environment will develop, is that they can still prevent the Prisoners' Dilemma problems, if they can foresee all the different paths the developments might take. The

<sup>38</sup> This discussion does not assume that governments strive to maximize social welfare, but is also compatible with a range of other more 'politically-influenced' objectives.

parties can then write a fully ‘state contingent’ contract, which would specify commitments for each possible outcome of the underlying economic environment.<sup>39</sup>

There are two points to note about these contracts. First, there is a strong assumption that governments would use these contract forms if they could: whatever the negotiated distribution of surplus between the parties to the contract, the contract will not leave any gains unexploited — thus, under such a contract one cannot improve the position of one Member without worsening the situation for some other Member. Second, these three types of contracts share the feature that *they would not need to include an NT provision*.

The reason why we do not observe such contracts in practice of course stems from the fact that they would require an enormous amount of information, and would essentially require central planning at a global scale. It is simply not possible to foresee all future contingencies that may warrant a different pattern of trade. Similarly, it is not possible to fully list all the ways in which countries may influence each other through the use of domestic policy measures.

As a result of these informational problems, real world trade agreements have two generic types of deficiencies: first, the explicit bindings in the agreement are typically *inflexible* in the sense that they are insensitive to variations in the external environment. Consequently, when the environment changes, the bindings might move significantly out of line with what the parties to the agreement would have preferred. As we have discussed in another context,<sup>40</sup> safeguard mechanisms and other escape clauses can be seen as means to address this inflexibility. Second, virtually all domestic policy instruments are left unbound in trade agreements, potentially leaving the parties with plenty of scope to undo tariff bindings. In order to limit these problems, the bindings are complemented with vague provisions concerning the conduct of domestic policies. However, the exact interpretation of these provisions is left to future adjudication. In economic parlance, the contracts are highly ‘incomplete’.

This incompleteness of trade agreements is not without problems, however, since it invites a beggar-thy-neighbour use of domestic (unbound) policy instruments. A first line of defence in trade agreements against such conduct is the NT obligation. The essential function of this instrument is to make domestic measures *blunter instruments of protection*. In the case of taxation, the more ‘fine-tuned’ tax policy instruments governments have at their disposal, the more tempting it will be for them to pursue beggar-thy-neighbour policies. If domestic products have to be burdened with the

<sup>39</sup> The difference between the two contracts and the third is that the first two contracts would specify the commitments of the Members at each date. These would then vary over time in response to changes in the external environment. In the case of the fully state-contingent contract, the realization of these external events would be unknown at the contracting date, so the contract would specify commitments for each possible realization for each date. This would thus be a significantly larger contract, but would in principle achieve the same thing as the first contract.

<sup>40</sup> Horn and Mavroidis, ‘Review of the WTO US-Lamb Dispute’, in American Law Institute, *Principles of Trade Law: The World Trade Organization — The WTO Case-law of 2001* (2003).



higher taxes imposed on imported products, tax becomes a less attractive instrument of protection.<sup>41</sup>

## 6 Article III.2 and its Case-law in Light of the Above Framework

### A Allowing Legitimate Differential Taxation under Article XX Only

Relief for violations of Article III can be sought through recourse to Article XX. We do not believe this to be an attractive option.<sup>42</sup>

A first problem stems from the fact that Article XX seems to provide a positive closed list of legitimate objectives for government intervention.<sup>43</sup> But due to the same informational problems that caused the contract to be incomplete, making a complete list of all legitimate government objectives in Article XX would be practically infeasible.<sup>44</sup> In its absence, relief from the rigid requirement of equal taxation must be found under Article III itself.

A second problem with the Article XX route relates to burden of proof. A country invoking Article XX would have to show that the measure for which it seeks exemption is *necessary*, that is, according to the standing interpretation of the term, the least restrictive option to reach the objective sought. Clearly this might present serious problems for the party assuming the burden of proof. Hence, a different understanding of the SATAP requirement seems appropriate.

### B The Interpretation of SATAP

Assume that the NT provision for taxation requires WTO Members to tax foreign hats in the same way as they tax domestic autos. This might clearly be a severe restriction

<sup>41</sup> The GATT/WTO also contains another instrument, with a potentially even wider reach: the non-violation instrument. It is hard to imagine a provision that leaves more of the determination of the factual obligations under the contract to later adjudication.

<sup>42</sup> See also the discussion in Horn and Weiler, 'Review of the WTO *EC-Asbestos* Dispute', in American Law Institute, *supra* note 40, in particular as it concerns the WTO *Asbestos* dispute.

<sup>43</sup> For instance, suppose a country imposes 0% VAT on all cars of less than 1,000cc, and 30% VAT on all cars of more than 1,800cc. The country produces only the smaller category of cars. Another Member exports cars of 1,801cc, and is thus adversely affected by the measure. The importing country would then be forced to rely on Art. XX GATT. But since the country is poor, and with substantial income-inequality, its government believes that cars beyond 1,000 cc should be taxed much heavier than smaller cars, since these are luxurious items. Is such an objective covered by Art. XX.a? It may or may not be, depending on the understanding of the term 'morals' in Art. XX.a. If not, it could very well be the case that the importing country might see its law judged inconsistent with the WTO contract.

<sup>44</sup> The European Union experience is quite relevant in this respect: an exhaustive list of exceptions (Art. 30 (ex 36) of the Treaty of Rome) became non-exhaustive through interpretative interventions by the European Courts: first by inventing the 'mandatory requirements' (a list of grounds justifying policies which might lead to market foreclosure) and then by subtracting the so-called modalities from the list of Art. 28 (ex 30) *per* the *Keck and Mithouard* case-law. See also Weatherill, 'Pre-emption, Harmonisation and the Distribution of Competence to Regulate the Internal Market', in C. Barnard and J. Scott (eds), *The Law of the Single European Market* (2002), 41.

on the importing country's ability to pursue legitimate policy objectives, provided that these objectives call for differential taxation.

At the same time, the requirement to tax hats and autos equally would be unlikely to deter protectionist behaviour. Why? Since the lower tax on hats is not likely to induce potential buyers of autos to shift their spending from autos to hats any more than would potential consumers of many other products. Nor would a higher tax on autos increase the demand for hats to any significant degree. That is, there is *no direct competitive relationship* between imported autos and domestically produced hats, and it is thus unlikely that a pronounced protective *effect* of the differential taxation will be produced.<sup>45</sup> Assuming a certain amount of rationality on the part of the government, the lack of protective effect suggests that it is unlikely that *protectionist intent* would lie behind such a measure. Therefore, the very inclusion of the DCS/like requirement strongly indicates that Article III aims to punish protectionist tax differentials.

Protection is not defined as an *ex ante* prescribed outcome, but rather as a government stance. NT, the means to combat protection, is the response to an informational problem, and the basic problem for its implementation is to distinguish cases where differential taxation has protectionist motives from those where they are legitimate. This perspective has several important consequences for the appropriate interpretation of NT in the GATT context.

First, we should be careful not to assume the existence of information that would have enabled the parties to write more complete, and presumably more efficient, contracts at the outset. Furthermore, if the parties did not have enough information at the time of negotiations to formulate well-specified expectations about future trade outcomes, it would presumably be even harder for adjudicating bodies several years later to determine what outcomes the parties might reasonably have expected when drafting the contract. Consequently, we conclude on principle grounds that the legal right acknowledged by Article III should not be understood as a guarantee of specific *trade outcomes*. Instead, it seems reasonable to understand it as a right to expect a certain type of *behaviour* by trading partners at these future dates.

Such an interpretation can also be given a contract-theoretical support. As was explained, lack of information, broadly speaking, makes it impossible to implement any of the three types of potentially fully efficient contracts identified above. These contracts, which would all make NT superfluous, are expressed in terms of bindings of domestic policy instruments, and of trade outcomes. A different type of solution, although perhaps not equally efficient, would be to leave it to the parties to decide their domestic policies, and instead contract a certain *mode of behaviour* for the determination of these instruments. For instance, if each party could make a commitment to take into account the joint interests of the parties whenever determining domestic policies, much of the problem would disappear. The SATAP criterion can be seen as an attempt to take a step in this direction, by requiring GATT/WTO Members to abstain

<sup>45</sup> We will use the term 'differential' rather than 'discriminatory' taxation to denote tax schemes that imply a higher per unit tax on an imported than on a domestically produced product, the former being more value neutral.

from undertaking protectionist measures, thus protecting expectations concerning modes of conduct. The notion that Article III protects expectations concerning behaviour rather than trade outcomes has also been acknowledged in GATT case-law.

The analysis above implies that non-protectionist (legitimate) tax differentials are exonerated from an eventual Article III inconsistency. A crucial question is of course *what* should count as a legitimate objective for differential taxation? We would argue that this largely has to be left to governments to decide, for two related reasons. First, and as explained above, it is impossible to list all policy objectives that a government may have. The agreement is by necessity incomplete also in this respect. It must therefore be left to governments to specify their own policy objectives *ex post* the signing of the agreement.

Second, besides informational problems, democracy-related concerns might also argue in favour of such an approach: unless there is a clear federal vision, countries usually prefer to achieve gains from international cooperation through minimal transfers of regulatory sovereignty. In the case of long-term contracts like the GATT/WTO, an *ex ante* agreement on the future use of internal measures would to some extent 'strangle' the future functioning of the democratic discourse, by limiting regulatory choices.

With this in mind, we now turn to several issues that the case-law interpretation of SATAP raises.

### 1 What is Protection?

Given the central role of protection in Article III, one might expect the case-law of this article to have focused on its meaning, especially since no agreed definition of the term exists.

In the disputes addressed in this paper, the respondents did not seek to motivate their taxation schemes with reference to presumably legitimate policy objectives, such as for instance public health. To be sure, Japan did claim before the Panel that its legislation aimed at guaranteeing 'horizontal neutrality', that is, a similar tax burden for those similarly taxed.<sup>46</sup> The Panel rejected this argument because, in its view, the aim of the taxation is not relevant in the context of Article III but also because this was an *ex post facto* rationalization by Japan as such policy justification appeared nowhere in the Japanese law imposing tax discrimination.<sup>47</sup> Hence, the Panel's decision on *Japan* is in a way a reflection of the 'but for' test: first, the products concerned were like and DCS; second, foreign products were taxed more heavily than their domestic counterparts; and third, Japan, when enacting the legislation, did not state any policy objective to justify the tax differential. However, for protection of domestic production, one could legitimately conclude that the Japanese law had no other *raison d'être*. Before the AB, Japan reiterated its argument that the 'aim' of a legislation is important when interpreting Article III but did not *specifically* reiterate its argument that the aim of its legislation was to guarantee horizontal neutrality. Hence, technically speaking,

<sup>46</sup> *Japan*, at para. 4.132.

<sup>47</sup> *Ibid.*, at para. 6.25.

the AB did not have to confront such an argument. It seems that without defining what *protection*, the Japan Panel accepted (at least implicitly) a ‘but for’ test in order to establish a violation of Article III.2. At the same time, however, this solution can be used only in cases where no policy justification is offered for a tax differential by the taxing WTO Member.

In the other two disputes, the AB found instances of protection without developing a ‘top-down’ approach. In essence, the approach of the AB has been to say: ‘*we can’t define protection, but we (usually) recognize it when we see it*’. Thus, post-*Chile*, we still have no clear understanding of how the concept ‘SATAP’ is understood by the AB. We have before us positive findings that protection was afforded on a case-by-case basis, but we lack a reliable methodology to this end. We know that sometimes a substantial tax differential might suffice to show that a practice operates SATAP, and sometimes it does not, but not exactly when. And we do not know, except for the *de minimis* criterion, which factors are relevant to the definition of SATAP in presence of DCS products.

It should be acknowledged that the task of defining protection in an operational manner is not easy. But even a non-operational definition may help to provide some logic and coherence to the adjudication.<sup>48</sup> For instance, the absence of definition led to the unsatisfactory result in *Chile*, where the AB discarded evidence as to who bears the cost of taxation.

## 2 Intent versus Effect

As we saw in Section 3, the AB has explicitly rejected intent as a criterion, sometimes on the grounds that it is irrelevant as such, and sometimes since it is hard to prove. The AB has also argued that it is irrelevant whether measures have the effect of protecting.

Then, what *are* the relevant criteria? As we have seen, according to the AB, it is about the *protective application* of measures:

Although it is true that the aim of a measure may not be easily ascertained, nevertheless its protective application can most often be discerned from the design, the architecture, and the revealing structure of a measure.<sup>49</sup>

We must confess that we simply do not understand what the AB has in mind here. *What* is it that the structure reveals, if not that it is intended to protect? *How* can it be excluded that the measure helps to promote legitimate policy objectives, by only considering the design, structure, etc., without taking into consideration what these other policy goals might be?

Reading *Japan* between the lines (the ‘but for’ test), and some excerpts from *Chile* might suggest that the AB has not shut the door hermetically to an intent test. At the same time, elsewhere in both reports the AB gives the opposite impression.

<sup>48</sup> A recently developed framework provides a good example of the value of such an approach. See Bagwell and Staiger, ‘An Economic Theory of GATT’, 89 *American Economic Review* (1999) 215. Their ‘politically optimal equilibrium’, where countries neglect the terms of trade effects of their policy choices, seems to provide one natural definition of the non-protectionist situation referred to implicitly in Art. III GATT, even if its practical application seems problematic.

<sup>49</sup> *Korea*, at para. 150.

### 3 Chile as Evidence of the AB SATAP Test

*Chile* offers an excellent illustration of the fact that the AB test may lead to unsatisfactory results.<sup>50</sup> As stated above, in *Chile*, the AB was confronted with the Chilean argument that in the higher taxed category (over 39°) the majority of the products hit by high taxation (47 per cent as opposed to 27 per cent for beverages with less than 35° alcoholic content) were domestic and not imported products,<sup>51</sup> a fact that the AB itself admitted to, only to dismiss it in the following terms:

The cumulative consequence of the New Chilean System is, as the Panel found, that approximately 75 percent of all domestic production of the distilled alcoholic beverages at issue will be located in the fiscal category with the lowest tax rate, whereas approximately 95 percent of the directly competitive or substitutable imported products will be found in the fiscal category subject to the highest tax rate.<sup>52</sup>

The AB, however, nowhere mentioned what fraction of total consumption of alcoholic drinks of higher alcoholic content that the 95 per cent of imported products represent. It thus seems as if the SATAP requirement is satisfied regardless of whether Chilean producers produce the majority of the higher content alcohol consumed in Chile. Does this mean that even if only one foreign product is found in the higher alcoholic content category<sup>53</sup> (or, indeed, even if none is found, in application of the potential competition argument<sup>54</sup>), Chile would have still violated its obligations under Article III.2, second sentence? The AB decision seems to take into account *some* effects, disregards other effects, and probably neglects legislative intent (the AB as noted above, summarily dismissed the policy justifications advanced by Chile without explaining whether intent matters and if so, how much).

### C The Interpretation of Like/DCS

We now turn to the second dimension in which the ambit of Article III is restricted — the product pairs to which it applies. As in the case of the discussion of SATAP, we will first draw some conclusions from the theory laid out in Section 5, and then proceed to the case-law interpretation.

Consider a policy measure that imposed a higher tax on a foreign product than on a domestic product that buyers treat as a close substitute. There are two ways in which this measure could escape a prohibition under Article III. One would arise if the likeness definition was not based on the market relationship between products, but on their policy-relevant aspects. Provided that products differ from the point of view of a legitimate policy objective, they might then be viewed as unlike (*à la Gas Guzzler*), even if viewed as like in the market place, and would thus escape Article III.

<sup>50</sup> See the analysis by Ehring, 'De Facto Discrimination in World Trade Law: National and Most-favored Nation Treatment — Or Equal Treatment', 36 *Journal of World Trade* (2002), on this issue.

<sup>51</sup> *Chile*, at para. 58.

<sup>52</sup> *Ibid.*, at para. 67.

<sup>53</sup> This is also criticized by Ehring, *supra* note 50.

<sup>54</sup> That is, following *Superfund*, a WTO Member violates its obligations under Art. III.2 by taxing domestic products more favourably than foreign like/DCS products even if no imports are observed when the dispute is referred to the WTO adjudicating bodies.

Such an approach has certain attractive features: for instance, if there are severe environmental hazards from consumption of the imported product but not from the domestic products, ‘everyone’ would agree that the products are in some intuitive sense ‘unlike’, even if consumers happened to disregard the environmental effects.<sup>55</sup>

We would nevertheless argue against this approach for several reasons. First, it requires the adjudicating bodies to decide on what are, and what are not, legitimate policy objectives, since this distinction is what determines whether products are like or unlike. But this would violate the principle of GATT being a negative integration scheme.<sup>56</sup> It must be left, in the absence of explicit transfer of sovereignty to this effect, to governments to formulate policy objectives.

Second, for differential taxation to be legal under Article III, it should not suffice that it is intended to serve some legitimate purpose, but also that it is designed so as not to be unduly burdensome for trading partners. If the likeness determination is based on the legitimacy of policies, then a measure that is motivated by a legitimate policy objective but is designed so as to push the cost on to trading partners will not be caught under Article III, since products will be found to be unlike, and thus not subject to any further discipline imposed by Article III. If instead likeness only concerns the competitive situation in the market, the design of the policy can be addressed in the SATAP test.

Third, there is an odd feature in the approach of letting ‘legitimate’ government objectives affect the likeness determination: the *need* for government intervention in the market place typically arises from the fact that consumers and/or producers do *not* distinguish between products when, in the government’s eyes, they should. Hence, legitimate distinctions will typically be made because consumers treat products as like, while at the same time under this approach, these distinctions will be exonerated from liability under Article III precisely because the products are determined by adjudicating bodies to be *unlike*. While this is not a fundamental objection to this approach, it would require the distinction between two different concepts of likeness: likeness as perceived by the market and as perceived by the government.

Our preferred approach is instead to see like/DCS (Article III.2) as the ‘fishing net’ that would catch the potential illegalities, and SATAP (Article III.1) as the criterion according to which the ‘catch’ would be evaluated. For this inspection to weed out those measures that are pursued in legitimate ways, one would have to look at the stated intent behind the policy to determine whether, given this intent, the measure is designed in a way that somehow minimizes harm to trading partners. If not, there would be a presumption that the true intent behind the measure is rather to protect.

The like/DCS criteria should hence be seen as ‘technical’ descriptions of the functioning of the market, and should not be influenced by value judgments concerning the legitimacy of the regulation. There are several aspects of this approach that merit comment.

<sup>55</sup> See Horn and Weiler, *supra* note 42, for a more extensive discussion of this approach.

<sup>56</sup> The idea of letting the likeness test take policy objectives into account was, as already noted *supra*, essentially adopted in the *Gaz Guzzler* dispute.

First, such an approach allows a certain formalization of the methodology employed by adjudicating bodies to determine the degree of likeness/DCS. This has the advantage not only of putting some discipline on these bodies in this important part of their work. The explicit formalization of methods for determining likeness also makes it possible to discuss the methodology employed, in order to refine it. This is not possible to the same extent when the determination of the competitive relationship in the market is mixed with the adjudicating bodies' perceptions of whether the differential taxation has legitimate motives. The suggested approach corresponds closely to the procedure in anti-trust, where the relevant market concepts are essentially a technical construct aimed at helping the anti-trust authority assess the impact of, say, a proposed merger.<sup>57</sup>

Second, the principle that the like/DCS element should reflect features of the market should not be confused with the question of how to determine these features *in practice*. We will return to this issue below.

Third, and as also pointed out by one author,<sup>58</sup> the degree to which products are like/DCS is in general determined not only by demand-side factors, but also by the supply side. For instance, if a domestic firm is capacity constrained, then a favourable tax treatment might increase its profitability, and in this sense might provide protection. But it would not significantly reduce the demand for the foreign product, since the protected firm has no capacity to expand. In order to deduce the harm caused by discriminatory taxation, one thus needs to take both producer and consumer behaviour into account.

Case-law seems to have placed emphasis on demand-side factors only.<sup>59</sup> This approach could possibly be justified in cases where a very high degree of demand-side substitutability is established, provided that this can be shown to be *sufficient* for a high degree of competitiveness. But to the best of our knowledge, no such assumption has been established, intuitive as it seems. And in cases where there is a lower degree of demand substitutability, the supply-side interaction must also be considered.

### 1 *Econometric and Non-Econometric Evidence on Like/DCS*

It is important to distinguish between the conceptual issue of what likeness/DCS should ideally capture, and the methodological issue of how to establish in practice whether a pair of products fulfils this definition. Case-law in GATT/WTO, as shown in Section 2, has largely embraced the principle that the notions of like/DCS are ultimately about features of the market.

Given a well-defined *purpose* of these concepts, we can determine the appropriate indicator. For instance, if the degree of likeness is meant to capture the extent to which an increase in the tax on the imported product benefits the domestic product in terms of an increased sales volume, then the appropriate concept is that of cross-price

<sup>57</sup> We will return to a fuller discussion of this relationship below.

<sup>58</sup> Neven, 'How Should Protection be Evaluated in Article III GATT Disputes?', 17 *European Journal of Political Economy* (2001) 421.

<sup>59</sup> The more recent *Asbestos* report by the AB reflects a very superficial discussion of how supply-side considerations can be of interest when discussing likeness. It is difficult to assess whether the discussion forms an integral part of the *ratio decidendi* of the report or whether it is a mere *obiter dictum*. See Horn and Weiler, *supra* note 42.

elasticity (CPE). Note that the CPE concept then captures *everything* that is relevant for the likeness assessment. There is in principle no need for any other type of evidence, such as end-uses.

When applying this concept of likeness to a particular situation, one would thus need to determine the CPE between the two products. The ideal method for doing this would be to statistically (econometrically) calculate the CPE using high-quality data from the particular market under study. If data for some reason were known to be of such quality, there would be no need to bring in any additional indicators, the econometric estimate would say all we need to know about the CPE, and the CPE says all we need to know about the relationship between the two products.

In practice, we hardly ever have access to data that is known to be of such high quality. Instead, there are typically a large number of deficiencies with the data. It therefore becomes necessary to partially or fully rely on other sources of information. The case-law has employed a number of such indicators, and we will discuss these below. It should be noted, however, that as long as we stick to the notion that the likeness concept in principle is captured by the CPE (or some other economic concept), then these indirect indicators should be used to compute the CPE. That is, these indicators provide no relevant information beyond what is captured in the CPE.

This discussion has assumed that the likeness definition was in principle captured by the CPE concept. The more general point, however, is that econometrics is the primary tool to use, whatever the particular choice for the concept of likeness. For instance, if likeness is in principle captured by the elasticity of substitution (EOS), then the first choice would be to econometrically seek to compute the EOS. It is only when it is not feasible to compute a reliable estimate of the EOS that other indicators will be of interest, and then only to the extent that they shed light on the EOS.

Against this background, we find it noteworthy, to put it mildly, that case-law has evolved almost entirely as though econometrics did not exist. With the exception of *Japan*, econometric evidence seems to have had no influence on panels' or the AB's understanding of the issue. In the other disputes (and to an extent, this was the case in *Japan* as well), the determination of a likeness/DCS relationship was based on non-econometric indicators. This is not to suggest that a reliance on econometrics would always 'solve' the problem of determining likeness, nor that it would be unproblematic. However, we fail to see why econometric tools should not be employed whenever their application would shed light on the issues involved.<sup>60</sup>

We will now provide some remarks on the manner in which non-econometric indicators have been employed in case-law.

#### (a) Physical and Perceptual Similarities

The demand-side substitutability between a pair of products is determined by consumer *perceptions* of the characteristics of the products. Contrary to what is reflected in the *Korea* Panel report,<sup>61</sup> consumer perceptions of differences between products cannot be dismissed just because they are created through advertising, even

<sup>60</sup> Art. 13 DSU could definitely be used by panels wishing to invite economic/econometric testimony.

<sup>61</sup> WTO Doc. WT/DS 75, 84/R of 17 September 1998, at paras 10.65–10.66 [hereinafter *Korea* Panel].



if the products at hand are physically identical. To start with, if consumers, for whatever reason, do not see products as similar, there will not be a pronounced effect of, say, lower taxation of domestic firms for foreign sales, and a protective intent behind the measure is less likely.

Second, one may question whether it would be consistent with the overarching purpose of the TRIPs agreement to dismiss perceived product qualities simply because they are created through advertising. The value attached to the property rights that the TRIPs agreement is meant to protect is often created partly through advertising, which creates perceived differences between physically very similar products. More generally, the adjudicating bodies would be walking a dangerous path if they were to judge on which differences consumers 'should' see between products.

But physical similarity may nevertheless be informative in situations where there is a lack of evidence on consumer perceptions, in two respects. First, it is likely to indicate an *increased probability* that products are, with current knowledge about products, perceived as close substitutes. Second, it may suggest that consumers in the future, after having learnt about product characteristics, may perceive the products as close substitutes. In a nutshell, very similar physical characteristics may raise a warning flag that a finding of low substitutability may be wrong, but is not conclusive evidence *per se*.

#### (b) End Uses

Economic analysis normally assumes that consumers' preferences and demands are defined over products. However, from the point of view of economic theory one can also assume that consumer preferences are defined over various 'needs'; for instance, a very crude description would be to distinguish the need for nutrition from that for shelter from the climate. If two products satisfy the same need in *all* respects, they are perfect substitutes from the consumer's point of view. The problem with this approach, however, is the arbitrariness in the classification of *needs*. For instance, do Korean consumers have a need for 'relaxation', or for 'evening relaxation', or for 'evening relaxation brought about by external substances'? Depending on how this arbitrary distinction is drawn, one ends up with very different conclusions with regard to the degree of demand-side substitutability. Consequently, an end-use criterion has to be employed with a great deal of caution in practice.

#### (c) Distribution Channels and Points of Sale

Transportation costs may hence interact with consumer preferences in complicated ways. It is possible, as maintained in case-law, that sensitivity to price differences increases when products are sold through the same outlets, and that discriminatory taxes are more harmful to exporters in this case. For instance, a foreign and a domestic store selling the same product in a shopping mall are more likely to be engaged in intense competition than if they were located far from each other.

But on the other hand, a basic rationale behind shopping malls is that consumers incur fixed costs of transportation when shopping. Consumers therefore typically prefer to concentrate shopping to a few outlets, and when offered a wide selection of products at the same outlet would purchase more than otherwise. It is therefore

possible that discriminatory taxation may be more harmful in situations where imported and domestic products are sold through separate outlets, since consumers may be unwilling to incur the fixed costs associated with transportation.

The AB has not discussed the role of transport costs in the context of distribution channels at all.

(d) Evidence from Other Markets

Lacking reliable estimates of cross-price elasticities, for instance, for the market concerned, thorough studies of other markets with similar structures could be informative. However, this similarity needs to be verified through information on the determinants of demand, such as income levels, tastes, and so on. Absent such verification, the determination of the relationship between products will be highly speculative, and no matter how low the *prima facie* standard is, when it comes to the issue of burden of proof, it is definitely a higher standard than pure speculation.

Evidence from other markets has so far been employed only in *Korea*. However, in this dispute the AB did not establish the similarity/comparability between the Japanese and Korean markets before using evidence from the former to make its case about substitutability between alcoholic drinks in the latter.

(e) Price Levels and the Degree of a Competitive Relationship

The case-law has addressed several aspects of the relationship between price levels and the competitive interaction between products. A first issue is whether large differences in consumer prices may indicate that products are not like or DCS. The *Korea* Panel seems to believe that this is indeed the case in principle, even though the factual evidence in *Korea* pointed in the opposite direction:

... [T]he 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.<sup>62</sup>

It seems to us that while large differences in prices in a situation with a non-discriminatory tax regime might signal that the products are not very close substitutes in consumption, it is less clear what conclusion may be drawn with regard to the question of whether products should be considered as like/DCS.

In order to determine whether differences in price levels are informative or not, we first need to be more precise as to what we want to measure. As argued above, we see the like/DCS criteria as a means of limiting the reach of Article III to cases where there is plausibly an intent to protect behind differential taxation. Such an intent is more likely when a less favourable tax treatment of imports has a strong protective effect. In order to implement this principle, we thus want to determine the degree to which two different tax structures — the existing and the alleged non-discriminatory one — yield very different outcomes and, in particular, the degree to which the imported product is

<sup>62</sup> *Ibid.*, at para. 10.94.

hurt by the alleged discriminatory regime. There seems to be no clear-cut answer to the question of how this response to a change in the tax structure (the movement from the discriminatory to the non-discriminatory or vice versa) depends on the differences in absolute price levels. The answer will depend on a number of factors that are yet to be specified, including whether the protective effect is to be measured in terms of reduced sales, profit margins, or other indicators, whether it is measured in relative or absolute terms, how the tax structures differ, and so forth.

A second type of issue relating to price levels is the question of whether information about demand obtained during a period when prices moved in a certain range can provide information about how consumers will respond when prices move significantly outside this range. The *Korea* Panel seems to argue against this:

If one is asking about the response to potential price changes, it is difficult to understand how a question about current behaviour will elicit a useful response. . . . 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 restriction.<sup>63</sup>

This claim is somewhat dubious, if seen as a general statement concerning the limitations of economic/econometric analysis. Consumer purchases are determined by underlying preferences, and these can be empirically deduced by systematically studying consumer behaviour. This knowledge can in principle, at least, be used to predict purchasing behaviour under other circumstances, such as when prices move to a different range, since the same underlying preferences are also at play there.

It may be argued that if the range in which prices have moved historically differs substantially from the range of prices in the future, possibly as a result of the cessation of discrimination, then historical data may not be very informative. Clearly, if we want to estimate demand for price levels that are far outside the range for which we have data on purchasing behaviour, the estimates may not be very reliable. However, one cannot just dismiss the possibility of predicting consumer behaviour outside this range. Also, it remains to be shown that the responsiveness to price changes would be systematically *underestimated* if one were to use data in one price range to predict responsiveness in another range.<sup>64</sup> Thus, a trade opportunities test is not irreconcilable with a methodology employing historical data.

<sup>63</sup> *Korea* Panel, at paras 10.91–10.92. To the extent that the Panel has in mind situations where there is *no* evidence on current behaviour, the second part of the quote is obviously correct, strictly speaking.

<sup>64</sup> As an illustration of the opposite case, suppose that consumers allocate the constant amount *I* to their consumption of *soju* and vodka, and that their preferences can be represented by a so-called constant elasticity of substitution utility function; this is a commonly employed specification in empirical economics. The demand for whisky would then be in the form

$$D_w(p_s, p_w) = \frac{p_w^{\rho-1}}{p_w^\rho + p_s^\rho} I$$

where the parameter  $\rho < 0$  captures the constant elasticity of substitution between the two beverages; the larger its absolute value, the higher the elasticity of substitution. The cross-price elasticity of the demand for whisky would then be:

$$\frac{\partial D_w}{\partial p_s} \frac{p_s}{D_w} = - \frac{\rho}{(p_w/p_s)^\rho + 1}$$

A third issue related to price levels discussed in case-law is the possibility that studies based on historical data on consumer behaviour fail to take into account how consumer habits and information may change in response to price changes. That is, not only would consumers increase their consumption of imported alcohol if prices fell due to a removal of the discriminatory taxation, they might also gradually learn more about the imported products and, as a result, increase their consumption at given prices. This possibility indeed complicates matters substantially, and raises the more general issue of the interrelationship between government regulation/trade policy and consumer preferences. For instance, a ban on sales of hormone-treated beef will most likely affect the general perception of the danger of consuming beef, and will thus likely increase the support for a sales ban. This problem is much more difficult to handle econometrically. In situations where this phenomenon is likely to be important, it will be necessary to rely on non-econometric evidence of the potential degree of competition between products.

## 2 *The Like/DCS Criteria and Relevant Product Market Definitions in Anti-trust*

The *Korea Panel* discusses and dismisses the idea of seeking guidance in competition law applications in the same paragraph:

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 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.<sup>65</sup>

We are not convinced by the Panel's reasoning, to the extent that we can understand it. First, we do not see that the differences between the purposes of the two types of law are as important as is claimed. The oft-maintained purpose of Article III — to protect expectations of 'competitive relationships' — seems very similar to the

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As can be seen, this expression depends only on the relative price of the two products. In particular, it is readily shown that if whisky were to become cheaper relative to *soju*, the cross-price elasticity of whisky with respect to the price of *soju* would fall. Hence, if we were to estimate the cross-price elasticity of whisky on data stemming from a period when the relative price of whisky was high, and employed this estimate in a situation where the relative price of whisky had fallen, we would *exaggerate* the responsiveness of whisky demand to changes in the tax structure at the new relative price level.

On the other hand, the cross-price elasticity of *soju* with respect to the price of whisky would be:

$$\frac{\partial D_s}{\partial p_w} \frac{p_w}{D_s} = - \frac{\rho}{(p_s/p_w)^\rho + 1}$$

Hence, if the price of whisky relative to the price of *soju* increases, the cross-price elasticity of *soju* with respect to the price of whisky increases. Consequently, if we estimate this cross-price elasticity on data stemming from a period when the relative price of whisky was high, and employed this estimate in a situation where the relative price of whisky has fallen, we would *underestimate* the responsiveness of whisky demand to changes in the tax structure at the new relative price level. In conclusion, whether the focus is on the cross-price elasticity of demand for the imported or domestically produced product is thus the determining factor in whether the effect of a removal of a discriminatory measure is over- or under-estimated when data taken from one price range is employed in another range.

<sup>65</sup> *Korea Panel*, at para. 10.81.

main purposes of competition law — to protect ‘fair’ competition, or competition in general. Second, the *method* employed to delineate the relevant market in anti-trust seems to be confused with the *benchmark values* it employs, and that effectively determine the scope of the market.<sup>66</sup>

When applying Article III the adjudicating bodies find themselves in basically the same situation as competition authorities: both types of bodies have to implicitly (or preferably explicitly) determine a counterfactual situation. On the competition law side, the counterfactual is a situation where the proposed merger is allowed, or where the allegedly illegal business practice is not used, and on the trade law side it is one where the allegedly illegal internal measure is not employed. The estimated effects will in both cases depend crucially on how wide the market is assumed to be.

Of course, the methods employed by competition authorities could often be refined. Nevertheless we feel that these methods are significantly more developed than those employed by adjudicating bodies in the WTO, and we believe that a fair amount could be learned from the handling of competition cases. To start with, there seems to be a better understanding of the need to relate market classifications to the underlying purposes of the laws.<sup>67</sup> Competition authorities also take into account not only demand-side substitutability, but also supply-side features. Of course, the resources at the disposal of competition authorities often vastly exceed those of adjudicating bodies in the WTO. However, these bodies already have the legal option of using experts. It is unfortunate that this has not been taken up for market definitions so far.<sup>68</sup>

It should be said that there are already in practice significant similarities between approaches in the two fields. In particular, just as WTO adjudicating bodies often rely on several indicators (end use, physical similarity, etc.), competition policy authorities also rely on a number of indicators, some ‘harder’ such as econometric analyses, but some much softer, and they typically do not apply any formal hierarchy as to the importance of these measures.<sup>69</sup>

Finally, we are not suggesting a ‘lock, stock and barrel’ approach, but simply that the adjudicating bodies should open the door to a potentially useful source of inspiration.

## **D *The Interpretation of Direct and Indirect Taxes***

The like/DCS criteria were seen above as restrictions on the type of product pairs that fall under Article III. A similar question concerns the type of taxation schemes that it would apply to. Article III is unclear on this point. Indeed, in the case of like products, Article III.2 refers to taxes on foreign products that are ‘directly or indirectly’ in excess

<sup>66</sup> For instance, using the SSNIP test, the width of the antitrust market would depend on whether one uses a 5% or 10% price increase norm.

<sup>67</sup> For instance, as stated by the European Commission, ‘[t]he concept of relevant market is closely related to the objectives pursued under Community competition policy’. See Commission Notice on the definition of the relevant market for the purposes of Community competition law. OJ C 372 of 9 December 1997, at 2.

<sup>68</sup> We also see here an important role for a substantially strengthened Economic Research Division in the WTO.

<sup>69</sup> It can be noted that recent developments in EC case-law indicate that the Commission will in the future be required to use even more refined analysis than is currently undertaken.

of those levied on domestic products. ‘Directly’ may here be taken to refer to a tax on the products concerned, and ‘indirectly’ would then be other ways in which taxes affect the products concerned. Thus, the text does not impose any limits on the degree to which indirect effects of taxation fall under the purview of the provision. The case-law has not established clear-cut criteria either. What it has done so far is to interpret Article III so as to apply not only to taxation schemes that *de jure* distinguish between foreign and domestic products in this manner, but also to tax systems that *de facto* taxes this way.

In our view, determination of the limits of ‘indirect’ is crucial to defining the ambit of Article III. The text in Article III.2 restricts Members’ freedom to setting internal ‘taxes’ on imported products such that they are ‘directly or indirectly’ in excess of those on domestic products. This raises the fundamental question of what kind of comparisons can be made. For instance, suppose an importing country levies a tax on the income of crane operators in harbours, but no similar tax exists for truck drivers who happen to transport domestic products. This will tend to favour domestically-produced autos relative to imported ones. Should this be objectionable under Article III? That is, should ‘indirectly’ in the text be interpreted to include taxes not levied directly on products? If so, how far down the value chain should this go? A related question is whether one should consider the incidence of the *whole* tax structure. If the answer is no, that only one tax can be examined at the time, what is the unit of account of taxes? Is the environmental tax law ‘one tax’, or is it one or two specific rates that are covered? Or, assume that the overall tax scheme of a WTO Member benefits imports, but that some of its features confer a benefit to domestic production. Can an exporter attack only the latter features without running the risk of having to face an overall assessment by a WTO adjudicating body? There is no clear response to this question, although a *Chile*-type approach would probably answer this question in the negative.

## 7 Concluding Remarks

The GATT is a highly incomplete contract. In particular, it leaves the determination of what are admissible and not admissible internal measures to adjudicating bodies. In order to provide some guidance, it includes an NT provision. As noted in the Introduction, Article III may be very far-reaching, depending on its interpretation, and may lead to conflicts with other policy objectives. This article has sought to shed light on the way in which the provision has been interpreted in case-law, and has sketched out a partly alternative interpretation.

Two broad observations stemming from our analysis can be made:

(1) The notion of ‘protection’ is central to Article III, and yet has not been defined in the case-law. Defining protection is admittedly not a simple task. Nevertheless, the lack of a definition severely hampers the understanding of the key terms appearing in Article III.2: ‘like’/‘DCS’ and the ‘SATAP’ requirement. It is difficult to understand the methodology that the AB employs when defining the former term. With respect to the latter, confusion is even greater: the AB has discarded an effects test, and has not

embraced an intent test either. As a result, what common sense would accept as a non-protectionist intervention ends up being proclaimed a violation of the GATT contract (*Chile*).

(2) The GATT is an inherently economic contract, and its proper interpretation cannot be addressed without a vision (theory) of the economic forces, and the overall regulatory environment it seeks to influence. The lack of clear case-law definitions of the key terms in Article III seems to us to reflect the absence of such a vision by the WTO adjudicating bodies.