



Empirical analysis of the national treatment obligation under the WTO: The case of Japanese *shochu*



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ARTICLE INFO

Article history:

Received 17 February 2017

Revised 28 July 2017

Accepted 2 August 2017

Available online 1 September 2017

JEL classification:

F13

L66

H21

Keywords:

National treatment obligation

WTO

Random-coefficient discrete-choice model

SSNIP test

ABSTRACT

The national treatment obligation, along with the most favored nation obligation, is an important principle of non-discrimination adopted by the World Trade Organization. It requires that foreign products be treated no less favorably than national products. This paper empirically examines the 1996 WTO recommendation that a Japanese distilled alcoholic beverage, *shochu*, be classed as a “directly competitive or substitutable product” with regard to other distilled drinks, and thus that not taxing similarly be in violation of its national treatment obligation. Demand estimates obtained from a random-coefficient discrete-choice model reveal that a substitution pattern of *shochu* is far more complicated than that presumed by the WTO. Upon the WTO recommendation, Japan made all distilled alcoholic beverages be taxable at the same level. Our simulation analysis indicates that the tax revision, while it reduced the tax revenue, improved Japanese national welfare.

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1. Introduction

The national treatment (NT) obligation, along with the most favored nation (MFN) obligation, is an important pillar supporting the principle of non-discrimination at the World Trade Organization (WTO). Whereas the MFN obligation requires equal treatment for goods from different nations, the NT obligation requires the treatment of imported goods, once they have cleared customs, to be no worse than that of domestically produced goods (See for example Jackson, 1997). The NT obligation was adopted as part of the undertaking by the WTO to prevent domestic tax and regulatory policies from being used as protectionist tools that would offset its efforts to reduce border restrictions to the flow of goods. The interpretation of the NT obligation is of critical importance to WTO members, because it has a profound impact on these countries' freedom to formulate domestic policy.

A major interpretative issue with regard to the NT obligation is to determine whether imported and domestic products are “directly competitive or substitutable,” under the stipulation of Article III.2 of the General Agreement on Tariffs and Trade (GATT) of 1994 (Grossman et al., 2013). While the absence of a “directly

competitive and substitutable” relationship between imported and domestically produced products precludes any possibility of protectionist measures contrast to the NT provision, it is interesting to note that case law has not clarified the interpretation of the terms. As Horn and Mavroidis (2004, 43) state, the WTO has no clear methodology to offer for the interpretation of the NT obligation, let alone for determining which products might be “directly competitive and substitutable.” To the best of our knowledge, this paper is the first to offer empirical evidence on the practical implementation of the NT obligation mentioned above in an application to Japanese alcoholic beverages.

In 1995, the EU, the US, and Canada requested consultations with Japan at the WTO, under the claim that a Japanese law taxed the locally produced alcoholic beverage *shochu* more favorably than several other import-dominated distilled alcoholic beverages (*Japan–Tax on Alcoholic Beverages* (WTO, 1996b), hereafter *Japan–Tax*). In November 1996, Japan accepted the WTO Appellate Body's recommendation that the complainants' claim be considered legitimate. To comply with the recommendation, Japan revised its Liquor Tax Law in 2000. An integral issue in this dispute was whether *shochu* and other distilled beverages were “directly competitive and substitutable” (DCS). In the dispute settlement process, the Appellate Body found that the decisive criterion in the determination of DCS is whether two products have common end-uses (*inter alia*) as shown by the elasticity of substitutive

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tion (WTO, 1996b, 25). This empirical issue addressed by the WTO is highly relevant for the concept of market definition often employed in the fields of industrial organization and antitrust economics. Nevertheless, to our knowledge, the economics literature has devoted hardly any attention to this issue. Using the existing methods available in these fields, this paper provides a practical implementation for us to assess how NT should be applied. To do so, we revisit the *Japan–Tax* dispute as an application, and evaluates ex-post whether the conclusion reached by the Panel makes sense; in other words, whether *shochu* and the other distilled beverages were in a DCS relationship with one another.

We first perform the test of small but significant and non-transitory increase in price (SSNIP) to determine whether *shochu* and other distilled beverages constitute a relevant market. The SSNIP test is a convenient method used by antitrust practitioners to identify the smallest market relevant to product competition. Our test reveals that, contrary to the WTO recommendation, *shochu* by itself forms a relevant market, independent of other beverages. Since the SSNIP test is known to be vulnerable to possible statistical biases arising from endogeneity and omitted variables, we proceed to estimate Japanese consumer demand for alcoholic beverages to examine the robustness of the result obtained in the SSNIP test. We estimate a random-coefficient discrete-choice model by using the method recently proposed by Dubé et al. (2012). Controlling for possible endogeneity in price, a substitution pattern is found far more complicated than that inferred from the SSNIP test: the cross-price elasticities are asymmetric and statistically different from zero.

The NT obligation is often deemed to be in conflict with national sovereignty. In *Japan–Tax*, the NT obligation placed severe constraints on the Japanese government's ability to freely determine domestic liquor tax rates. In response to the WTO recommendation, the Japanese government eventually imposed the same tax rates on all distilled alcoholic beverages sold domestically. We conduct simulation exercises based on the obtained demand estimates to assess whether and to what extent the tax revision improved welfare. The simulation results show that the liquor tax revision did increase social welfare of Japanese people. This is because the WTO recommendation corrected for the distortion arising from a higher tax on mostly imported liquor, whose demand is more price-elastic than a lower-taxed liquor, *shochu*, which is predominantly domestically produced during the study period.

The NT obligation has received notable academic attention. Horn (2006) offers the first formal analysis of the role of NT in bilateral trade agreements. He investigates the contractual incompleteness inherent in trade agreements over internal measures, and shows that if tariff agreements account for subsequent tax setting incentives, the NT obligation can improve welfare even when a first-best contract would call for discrimination against imported products. Saggi and Sara (2008) and Gulati and Roy (2008) point it out that when tariffs are exogenously fixed, NT may prevent a non-protectionist government from implementing welfare-maximizing policy and reduce social welfare. While the present paper does not share the analytical framework and motivations proposed by the above work, in that it does not deal with issues of incomplete contracts nor optimal taxation, this paper finds empirical evidence consistent with their theoretical claims that the NT obligation enhanced domestic national welfare.

The rest of this paper is organized as follows. The next section (Section 2) provides an overview of *Japan–Tax*. A major issue in the dispute was whether *shochu* was DCS to other distilled alcoholic beverages. Section 2 provides a notion to define the Japanese distilled-beverage market using the SSNIP test often used in antitrust economics. To check the robustness of the findings of the test, Section 3 estimates a random-coefficient discrete-choice model of Japanese demand for alcoholic beverages in general.

Using the estimation results, Section 4 assesses the extent to which the revised tax rates following the WTO recommendation had affected economic welfare of the domestic country. Section 5 provides concluding remarks.

2. Historical background and preliminary analysis

This section provides an overview of *Japan–Tax*, beginning with Section 2.1, which describes an overview of the WTO *shochu* dispute. A major issue in this dispute was whether *shochu* and other distilled beverages were “directly competitive and substitutable” (DCS) with each other. If they were, the complainant parties claimed, the wide gap between *shochu* taxes and other Japanese liquor taxes should have been unacceptable. The WTO Appellate Body concluded that *shochu* and the other distilled alcoholic beverages were DCS, and that the variable taxes violated the WTO rule. However, the Body did not offer any precise criteria for the determination of DCS. In Section 2.2, we suggest a simple approach corresponding closely to the procedure taken by an antitrust authority, assessing the impact of, say, a proposed merger between companies. Our analysis concludes that *shochu* constituted a relevant market on its own, implying that it and other beverages were not in a DCS relationship. To check the robustness of the result obtained in Section 2.2, we perform a demand analysis in the subsequent sections.

2.1. Overview of the WTO dispute

On June 21, 1995, the EU requested consultations with Japan concerning the internal taxes levied by the Japanese government on certain alcoholic beverages pursuant to Japan's Liquor Tax Law (WTO, 1995a). In the following month, the US (WTO, 1995b) and Canada (WTO, 1995c) joined the consultations. These three parties made essentially the same complaint: that Japan had acted inconsistently with Article III of GATT by applying higher tax rates to distilled alcoholic beverages, with the exception of Japanese *shochu*.

At the time of the consultations, Japan's Liquor Tax Law classified alcoholic beverages into seven categories, four of which were classed as distilled alcohol and as a result come under the direct focus of this study; these are *shochu*, liqueurs, spirits, and whisky (considered as a category of its own). The other three were brewed alcohol, including beer and cider; wine; and *sake*.¹ The liquor tax on distilled beverage was imposed according to quantity: in 1995, the tax rates, adjusted by alcohol content, ranged from 5280 Japanese Yen (JPY) per 10L on *shochu* to 24,558 JPY on whisky, as shown in Fig. 1.² While the law made no explicit distinction between domestic and imported alcoholic beverages, the complainant parties said, that Japan unduly favored (domestic) *shochu* over other distilled beverages, the latter of which were disproportionately imported. Indeed import share of *shochu* accounted for a mere 3.4% of domestic consumption in 1994, whereas whisky and other spirits accounted for 22.5 and 27.5% respectively.

The complainants and Japan submitted quantitative evidence to a WTO Dispute Panel. The Japanese government cited statistics on the correlation between price and consumption trends for the previous twenty years. In contrast, the complainants based their argument on the reactions of a sample of 400 *shochu* drinkers to a series of different combinations of counterfactual price levels for

¹ The category of *sake* includes *sake* compounds and *mirin* vinegar.

² To be precise, two kinds of *shochu* are sold in Japan, depending on the degree of alcohol content. *Shochu* group A contains 36% alcohol or lower, and *shochu* group B has a higher alcohol content. Because of the limited availability of price data, we use the sales-weighted average of the two groups in this study.

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