Alcohol Tax Dispute Expected

By Hayden Stewart

The World Trade Organization (WTO) will conclude in a few months its investigation of an alcohol tax dispute between Japan and the European Union (EU).

The organization ruling will complete a six-month investigation and a decade of efforts by the EU to focus world attention on Japanese alcohol taxes which allegedly discriminate against the consumption of whisky, liqueur, vodka and other *yoshu* (western-style spirits).

According to the European Business Community (EBC), a body of the EU, taxes in Japan are between 1.8 and 7.1 times higher for yoshu than for *shochu* (a traditional Japanese white spirit). This discrepancy makes yoshu relatively expensive and encourages Japanese to drink shochu as a substitute. "The current system of liquor taxation on distilled spirits in Japan regulates consumer demand in a highly discriminatory manner, to the benefit of shochu and at the expensive of all other distilled spirits."

As a result of Japan's tax system, the EBC alleges, shochu accounts for 77% of the Japanese liquor market. And, because few foreign companies produce shochu, their share is only 8% of total sales. By contrast, imports account for 33% of consumption in France, 34% in the United States, 42% in the United Kingdom, and 75% in Australia.

In appealing to the WTO for "a level playing field," the EBC has gained the support of the U.S., Canada and four domestic companies which dominate Japan's yoshu market.

Suntory is one major supplier of yoshu that supports the EU's position. Suntory occupies 60% of the Japanese market for yoshu, and imports account for 10% of its sales. "If the tax rate was equal for all types of liquor," says Koseki Shin'ichi, an advisor with Suntory's Research Department, "our sales would probably increase." He foresees rising sales of both domestic and imported distilled spirits.

In addition to distilling its own brands, Suntory sells in Japan more than a dozen internationally recognized brands like *Jack Daniel's* whiskey from the United States and *Beefeater Dry Gin* from the United Kingdom.

Another major supplier of yoshu, Nikka Whisky Distilling, concurs with the EBC's case against Japanese alcohol taxes. Nikka manufactures whisky, and also imports several foreign brands. Nikka's product line includes *Jim Beam* from the U.S., and *J&B* from the U.K., spokesman Fujioka Kanji reports.

Kirin-Seagrams is also a major supplier of yoshu to the Japanese market, producing several brands and importing a few dozen others. The company's foreign brands include *Chivas Regal* from the U.K. and *Four Roses* from the U.S. "Per alcohol percentage," confirms spokesman Teramoto, "there is a big difference in tax rates between whisky and shochu."

Jardine Wines and Spirits is Japan's leading importer of yoshu, reports marketing director and chairman of the EBC's Liquor Committee, Mungo Gilchrist. Jardine's selection includes *Hennessy V.S.O.P.* from France, *White Horse* from the U.K., and *I.W. Harper* from the U.S.

Competitive products

Despite alcohol taxes, the Japanese market continues to attract foreign companies with its size and its wealth. Japanese spend ¥6—¥7 trillion on alcohol each year and consume slightly less than 10 million kl. Beer, saké, distilled spirits and wine account for approximately, 72%, 15.8%, 10.9%, and 1.3% of this volume respectively.

Foreign companies are working hard to succeed in each of these markets, making alcohol a major Japanese import.

They are also the dominant suppliers of wine in Japan, accounting for 52.1% of total sales. However, the size of this market is small. In 1993, imports of wine exceeded 60,000 kl. Wine is sold primarily in western-style restaurants and retail stores. Says Gilchrist, "It is difficult to sell wine in Japanese-style restaurants."

By contrast, the popularity of beer has pushed up imports of this alcohol to more than 200,000 kl. annually, although foreign-made beer accounts for only 3.3% of total sales.

Imports of saké account for an even smaller percentage of total consumption, making their presence in the Japanese market nearly imperceptible. But imports are growing fast. Imports from within Asia, the U.S. and other countries amounted to 839 kl. last year and should exceed 2,000 kl. this year.

Distilled spirits create the second largest category of imports. Foreign producers have captured 8% of the liquor market, pushing up imports to 80,000 kl. annually.

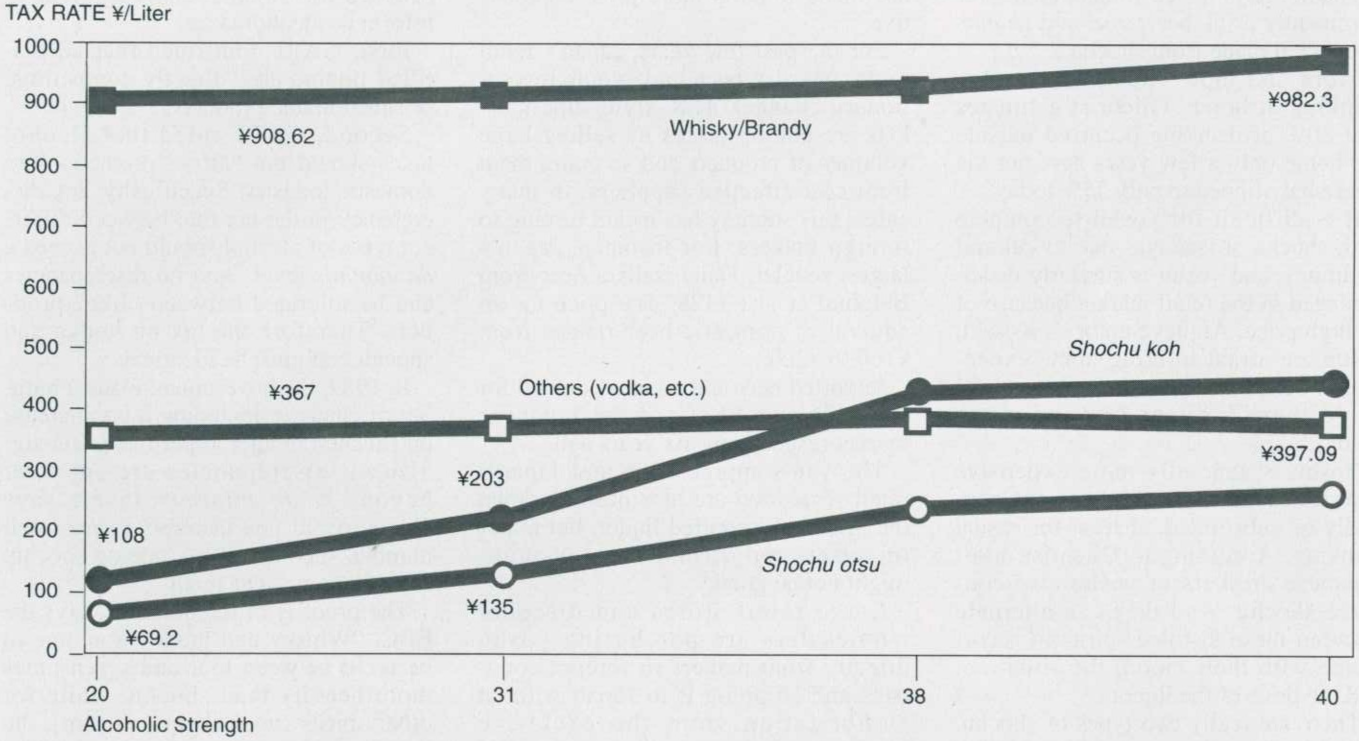
The Japanese market was largely closed to liquor imports until 1973, when the government liberalized this industry. Whisky, brandy, cognac, bourbon and other yoshu have since gained popularity with Japanese people.

Japanese discovered European Scotch and brandy first, Gilchrist reports. For instance, "*Hennessy* is a salaryman's valuable business partner," he says. Businessmen frequently consume *Hennessy* and other premium liquors while entertaining customers at expensive hostess bars in Tokyo's Ginza District and other up-scale areas.

At many of these up-scale establishments, many businessmen purchase a "keep bottle"-a new bottle of liquor with their name attached, which they leave at the bar and return to drink whenever they like.

Bourbon and whisky from North America are also visible in elite bars, says Gilchrist, but more frequently drunk in casual establishments and by young people. "These products are aimed at young drinkers who identify with American culture and trends."

Chart Items:
Taxes on Distilled Spirits



Source: European Business Community. Alcohol taxes are higher for yoshu than shochu, although shochu at 40% alcohol would theoretically be taxed at a higher rate than vodka at the same strength. However, no shochu is produced at this strength. According to the committee, almost all shochu is produced at an alcohol strength of between 20% and 30%, with 20% being the most common strength.

Liqueur, vodka, gin and rum are currently the most active segment of the import market, reports Teramoto of Kirin-Seagrams. "Because they are low in alcohol and mixed with fruit juice, cocktails have become very popular recently with the young generation, especially women. Liqueurs, vodka, rum and gin are necessary ingredients in making cocktails."

The post-bubble market

The current trade dispute is not about competitiveness, but taxes. Foreign brands are highly competitive in the market for yoshu. Indeed, imports have grown from nearly zero to 27.4% of total yoshu sales over the past two decades. Instead, foreign companies are concerned about the size of Japan's yoshu market. It is currently less than one-third the size of the market for shochu. And the yoshu market is shrinking, not expanding. In 1989 shochu accounted for 61% of distilled spirit consumption in Japan, whereas it accounts for 77% today.

There are many reasons for the growing popularity of shochu and business people concede that culture may be one. Japanese have drunk shochu for more than 600 years, whereas they have produced whisky for only 72 years.

Nonetheless, says Gilchrist, Japan's four-year economic slowdown and the high tax rate on yoshu are primary reasons.

First, customers are patronizing elite bars less frequently as a result of the bursting of Japan's "bubble economy." "Keep-bottles" are less popular nowadays and many hostess bars are even closing their doors. Gilchrist is admittedly worried about the impact of these trends on sales of premium European Scotch and brandy.

Instead of drinking in expensive bars, says Nitta's Fujioka, Japanese are increasingly drinking at inexpensive establishments like the traditional *izakaya* (a cheap bar) where yoshu is rarely available. Says he, customers there predominantly drink beer, saké and *chuhai* (a cocktail made from shochu.)

More and more Japanese are also drinking at home. Gilchrist estimates that 40% of drinking occurred outside the home only a few years ago, but the figure has slipped to only 35% today.

It is difficult for yoshu to compete with shochu at izakayas due to cultural traditions, and yoshu is similarly disadvantaged in the retail market because of its high price. Argues Suntory's Koseki, "Men are afraid to bring home expensive alcohol because their wives will scold them for spending too much money."

Yoshu is generally more expensive than shochu, and the products can generally be substituted, at least for casual drinking. According to Gilchrist, most Japanese drinkers of yoshu also consume shochu. And they can alternate between these distilled spirits in accordance with their mood, the situation, and the price of the liquor.

There are really two types of shochu. One, *shochu otsu*, is a traditional drink with a "blue collar" image.

Shochu koh is the other type. It is clear and tastes like vodka. Indeed, both vodka and shochu koh are often mixed with water and fruit juice to create popular cocktails like the "screwdriver."

A price comparison of popular brands illustrates the problem. A 750 ml. bottle of *Johnnie Walker Red* whisky from the U.K. costs between ¥1,600 and ¥2,500. An equally large bottle of *Smirnoff Red* vodka from the U.S. costs between ¥850 and ¥1,800. But a 720 ml. bottle of *Jun Legend* shochu costs only ¥850 to ¥930. If taxes are subtracted from these figures, however, the prices are more similar at ¥760 to ¥1,660, ¥520 to ¥1,470, and ¥570 to ¥670 respectively.

"Price destruction"

Because yoshu is more expensive than shochu, imports of yoshu have not benefited from the yen's appreciation or other changes in the Japanese retail system which are giving a profound boost to imports of beer and wine.

The yen is more than 20% above its value a few years ago. This revaluation has made imports more price-competitive.

For the past few years, Japan's retail sector has also been undergoing revolutionary changes. U.S.-style supermarkets are cutting prices by selling large volumes of products and sourcing them from cost-effective suppliers. In many cases, this strategy has meant turning to foreign makers. For instance, Japan's largest retailer, Daiei, sells a beer from Belgium at just ¥128. The price for an equivalent domestic beer ranges from ¥160 to ¥220.

Imported beer and wine accounted for only 1% and 44.1% of the Japanese market respectively six years ago.

The yen's appreciation and Japan's retail revolution are also pushing down the prices of imported liquor, but major importers report that these changes might not be good.

Large retail stores and discount wholesalers are purchasing yoshu directly from makers in foreign countries and shipping it to Japan without authorization from the exclusive importer. Because these parallel importers do not pay for advertisements and other promotional activities, they can sell the alcohol for less than suggested retail prices. For instance, the suggested retail price of a 750 ml. bottle of *Johnnie Walker Red* is ¥2,500, but consumers can routinely purchase the product for ¥1,600 to ¥2,000.

Although prices are falling, high taxes on yoshu still make shochu the cheapest distilled spirit. The volume of imports (as well as domestic production of yoshu) cannot rise under these conditions. Falling prices are squeezing corporate profits instead. And executives fear that money for advertising may ultimately dry up.

The fermenting dispute

Last year's appeal to the WTO is Europe's second legal measure against Japanese alcohol taxes in the past 10 years.

In the mid-1980s, alcohol taxes were a similar point of contention between Japan and the European Community. At that time, the EC appealed to GATT for assistance. And, in 1987, GATT ordered the Japanese government to reform its alcohol taxes.

First, GATT confirmed that all distilled liquors are "directly competitive or substitutable products."

Second, GATT ruled that alcohol taxes should not "afford protection" to domestic industry. Specifically, any discrepancy in the tax rate between different types of alcohol should not exceed a *de minimis* level. And no discrepancies can be tolerated between "like" products. Therefore the tax on vodka and shochu koh must be identical.

In 1989, the government made a number of changes, including a tax increase on shochu (about ¥50 per liter). But significant discrepancies are apparent beyond a *de minimis* level, says Gilchrest. "If you increase a very small number, such as the tax rate on shochu, it is still somewhat small."

The proof is in the numbers, says the EBC. "Whisky and brandy continue to be taxed between four and seven times more heavily than shochu, while for other spirits (vodka, gin and rum), the tax rate is some two to three times higher."

Concludes the EBC, "The most transparent method [for calculating alcohol taxes] would be to levy a single rate of liquor tax on all imported and domestically produced distilled spirits on the basis of their alcoholic content, an "x" yen per liter of alcohol." The EBC points out that other countries have adopted this type of tax structure, including the EU itself and the U.S.

"We are optimistic that the WTO will agree with our case," says Suntory. And although companies are not trying to estimate their sales growth under a "fairer" tax structure, it is likely that they will benefit from Japan's retail revolution and the yen's appreciation in a way that is similar to the situation for importers of beer and wine. JJTI

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