11 October 1994

UNITED STATES - TAXES ON AUTOMOBILES

Report of the Panel
DS31/R

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I. INTRODUCTION

1.1 On 20 May 1992, the European Community requested the United States to hold consultations pursuant to Article XXIII:1 on three measures maintained by the United States, namely, the Corporate Average Fuel Economy (CAFE) regulations, the gas guzzler tax, and the luxury tax, as it applies to cars (DS31/1). These consultations were held on 15 July and 20 September 1992. As they did not result in a satisfactory solution, the European Community, in a communication dated 12 March 1993, requested the CONTRACTING PARTIES to establish a Panel to examine the matter under Article XXIII:2 (DS31/2).

1.2 The Council, at its meeting on 12 May 1993, agreed to establish a Panel on the matter and authorized the Chairman of the Council to designate the Chairman and members of the Panel in consultation with the parties concerned (C/M/263).

1.3 In document DS31/3, dated 2 August 1993, the Chairman of the Council reported that the Panel would have the following terms of reference and composition:

Terms of reference

> "To examine, in the light of the relevant GATT provisions, the matter referred to the CONTRACTING PARTIES by the European Economic Community in document DS31/2 and to make such findings as will assist the CONTRACTING PARTIES in making the recommendations or in giving the rulings provided for in Article XXIII:2."

Composition

Chairman: Mr. Thomas Cottier

Members: Mr. Carlos M. Cozendey
Mr. Adrian Macey

1.4 At the meeting of the Council on 12 May 1993, the delegations of Australia, Japan, and Sweden reserved the right to intervene in the Panel proceedings (C/M/263).

1.5 The Panel met with the parties to the dispute on 4-5 November and 16-17 December 1993. The delegation of Sweden orally presented a written submission to the Panel at the meeting held on 4-5 November 1993. The Panel submitted its report to the parties on 30 September 1994.

II. FACTUAL ASPECTS

2.1 This Panel concerns three United States (US) measures: the luxury tax on automobiles contained in the Omnibus Budget Reconciliation Act of 1990 ("OBRA 1990")[1] (hereinafter called the luxury tax), the gas guzzler tax on automobiles contained in the Energy Tax Act of 1978, as amended, and its Regulations[2], (hereinafter called the gas guzzler tax), and the Corporate Average Fuel Economy law contained in the Energy Policy and Conservation Act (EPCA 1975), and its Regulations[3], as amended (hereinafter called CAFE).

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[1] 27 U.S.C. 4001 et seq.

[2] 26 U.S.C. 4064 et seq. Regulations contained in 40 C.F.R. Part 600.

[3] 15 U.S.C. 2001 et seq. Other legislative materials in H. Rep. No. 340, 94th Congress, 1st Session 3 (1975); and S. Rep. No. 179, 94th Congress, 1st Session 6 (1975). Regulations in 49 C.F.R. Part 500.

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A. Luxury Tax

2.2 The OBRA 1990 imposed the luxury tax on the first retail sale of vehicles over $30,000, and on several other products. The tax was equal to 10 per cent of the amount by which the article's retail price exceeded $30,000 in the case of passenger vehicles, $100,000 in the case of boats, $250,000 in the case of aircraft, and $10,000 in the case of jewelry and furs. The automobile luxury tax is paid by the customer to the dealer who then submits receipts periodically to the US Internal Revenue Service. The automobile luxury applied to domestic and imported vehicles alike.

2.3 The law defines a passenger vehicle as any 4-wheeled vehicle that is manufactured primarily for use on public streets, roads, and highways and that is rated at 6,000 pounds unloaded gross vehicle weight or less. Limousines are subject to the tax regardless of their weight. Trucks and vans are subject to the tax on a gross vehicle weight basis. Vehicles sold for use in a trade or business of transporting persons or property for compensation or hire are not subject to the tax. Exemptions are also provided for exports and for vehicles sold to the Federal Government or a State or local government for use exclusively in law enforcement or public safety activities or to any person for use exclusively in providing emergency medical services.

2.4 In 1993, the US Congress enacted the Omnibus Budget Reconciliation Act of 1993. This Act repealed the luxury excise tax imposed on boats, aircraft, jewelry, and furs. It also modified the tax on passenger vehicles by indexing the $30,000 threshold for inflation occurring after 1990,which raised the threshold to $32,000 as of 1 January 1994.

B. The Gas Guzzler Tax

2.5 The gas guzzler tax is an excise tax enacted in 1978 on the sale of automobiles within "model types" whose fuel economy fails to meet certain fuel economy requirements. The tax is imposed on manufacturers. The levels of fuel economy below which passenger automobiles are subject to tax, and below which the maximum tax is imposed, are as follows:

Model year	Subject to tax if below:	Maximum tax if below
1980	15 mpg[4]	13 mpg
1981	17 mpg	13 mpg
1982	18.5 mpg	12.5 mpg
1983	19 mpg	13 mpg
1984	19.5 mpg	12.5 mpg
1985	21 mpg	13 mpg
1986 or later	22.5 mpg	12.5 mpg

2.6 Under the Energy Tax Act of 1978, the range of tax rates applicable in each model year was as follows:

Model year	Lowest rate	Highest rate
1980	$200	$550
1981	$200	$650
1982	$200	$1,200
1983	$350	$1,550
1984	$450	$2,150
1985	$500	$2,650

[4]Hereafter, "mpg" means "miles per gallon".

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1986 or later	$500	$3,850

2.7 In 1990, OBRA 1990 doubled the gas guzzler tax rates in effect since 1986; the current rates range from $1,000 to $7,700. The levels of fuel economy below which passenger automobiles are subject to tax, and below which the maximum tax is imposed remain at 22.5 mpg and 12.5 mpg, respectively. Thus, the tax rates are now imposed as follows :

If the fuel economy of the model type in which the auto falls is:	**The tax is:**
At least 22.5	$ 0
At least 21.5 but less than 22.5	1,000
At least 20.5 but less than 21.5	1,300
At least 19.5 but less than 20.5	1,700
At least 18.5 but less than 19.5	2,100
At least 17.5 but less than 18.5	2,600
At least 16.5 but less than 17.5	3,000
At least 15.5 but less than 16.5	3,700
At least 14.5 but less than 15.5	4,500
At least 13.5 but less than 14.5	5,400
At least 12.5 but less than 13.5	6,400
Less than 12.5	7,700[5]

2.8 The law defines an automobile as any 4-wheeled vehicle propelled by fuel that is manufactured primarily for use on public streets, roads, and highways (except any vehicle operated exclusively on a rail or rails) and that is rated at 6,000 pounds unloaded gross vehicle weight or less. OBRA 1990 subjected limousines to the tax without regard to their weight. The tax does not apply to light trucks, including mini-vans, as defined by 1977 National Highway Traffic Safety Administration (NHTSA) rules that exclude vehicles designed for off-highway operation, certain cargo-carrying vehicles, vehicles designed to transport more than ten persons, and vehicles designed to provide temporary living quarters. The tax also does not apply to any vehicle sold for use and used (i) as an ambulance or combination ambulance-hearse; (ii) for law enforcement purposes; or (iii) for other emergency uses prescribed by the Treasury Department regulation.

2.9 The Energy Tax Act requires that the fuel economy of a "model type" for a model year be determined by the US Environmental Protection Agency (EPA). The Act refers to model type as "a particular *class* of automobile as determined by regulation" by the EPA. The EPA determines the methodology for calculating the fuel economy for both the gas guzzler tax as well as for the Corporate Average Fuel Economy requirements (see below); it had earlier been tasked with calculations of fuel economy values for the US car labelling program for consumers. Under EPA Regulations, average fuel economy is calculated for each "model type" for a model year. Final determination of the gas guzzler tax amount is made by the Treasury Department's Internal Revenue Service in consultation with EPA.

2.10 The methodology for calculating fuel economy is based on segmenting manufacturer designs into categories on the basis of characteristics likely to significantly affect fuel economy. An explanation of this methodology, provided by the United States, is contained in Annex I. Beginning with the most general category and proceeding to the most detailed, the first category is the "model type". It is based on the characteristics of carline (the vehicle name), a basic engine description (number of cylinders, displacement, and fuel system), and transmission class (manual

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[5] 26 U.S.C., §4064 (a)

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or automatic, and number of gears). The second category is the "base level" which is a distinct grouping of design parameters that are independent of the names of the vehicles (carlines) which are contained in them. Thus, base level characteristics are the same as for model type, but inertia weight class is substituted for carline. Inertia weight class is a testing parameter that determines how the dynamometer is set to simulate the weight of the vehicle on the road. Therefore, the base level is a vehicle weight-sensitive parameter. The same base level may be contained in several carlines, therefore several model types, and a model type could contain several base levels.

2.11 The third category, a finer level of design description than the base level, is the "configuration level". In addition to the base level parameters, a configuration is also a unique combination of engine code (calibrations), transmission calibration, and axle ratio. Finally, the "subconfiguration level" is the most detailed level of description used in the testing program. It includes equivalent test weight and road-load horsepower. Equivalent test weight is a finer level of dynamometer inertia weight setting, and road-load horsepower is another dynamometer setting determined by the on-road drag factors on the vehicle (air drag, drivetrain drag, tire road resistance, etc.)

2.12 EPA, by regulation, specifies the data selection and averaging methods and imposes data requirements on manufacturers that assure that each base level is represented by at least one test from the highest selling configuration. The manufacturer can supplement this with additional data from other vehicles in the base level. Also, any fuel economy data generated from emissions testing are required to be included at this time. Design changes which add base levels or change certain other parameters automatically require new gas guzzler determinations. Whenever such a design change is adopted, the affected model types have their fuel economy values recalculated, but this is rare. If the recalculated fuel economy value changes by 1 mpg or more, the gas guzzler status is redetermined

2.13 Gas guzzler liability calculations are performed before vehicles are entered into commerce so that the tax can be displayed on the fuel economy label at the beginning of the model year, thus allowing the consumer to be aware of the fuel economy value and the extra cost at the time of sale. Since the model type calculation must be performed before the vehicle enters commerce, the calculation must be performed using sales projections. The procedure concludes by sales-weight averaging the base levels into their respective carlines to become model type fuel economy values. The tax is assessed on each automobile, based on the model type in which it falls.

C. Corporate Average Fuel Economy (CAFE)

2.14 The EPCA 1975 required that an average fuel economy value be calculated for each manufacturer's and importer's entire fleet of vehicles, or "corporate average fuel economy." The EPCA required that mandatory average fuel economy values be set for all manufacturers for each model year, which the average fuel economy of passenger automobiles and light trucks must at least meet[6]. The EPCA specified the levels of the fuel economy requirements for passenger automobile fleets for model years 1978-80 (at 18, 19, and 20 mpg respectively), and for 1985 and thereafter (27.5 mpg), and required the National Highway Traffic Safety Administration (NHTSA), which enforces the CAFE law, to set the requirements for model years 1981-1984 (set at 22, 24, 26, and 27 mpg respectively). Congress had selected the specific numerical requirement of 27.5 mpg to meet the goal of doubling average new automobile fuel economy by the year 1985. The CAFE law permits, but does not require, the National Highway Traffic Safety Administration (NHTSA) to amend the 27.5 mpg standard.

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[6]The CAFE program establishes lower fuel economy requirements for light trucks which includes mini-vans.

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2.15 CAFE requirements specify a minimum average fuel economy for passenger automobiles (or light trucks) manufactured by a manufacturer,[7] defined as any person engaged in the business of "manufacturing" automobiles.[8] According to the legislation, to "manufacture" means to produce or assemble in the customs territory of the United States or to import into the customs territory of the United States.[9] Thus, production or assembly of a vehicle in Europe or Asia would not be considered manufacturing for CAFE purposes, but importing the vehicle into the United States would.

2.16 The vehicles of all manufacturers within a control relationship are grouped together for CAFE purposes. The term "automobiles manufactured by a manufacturer" includes all automobiles manufactured by persons who control, are controlled by, or are under common control with, such manufacturer. It excludes all exported automobiles manufactured (as defined in the previous sentence) during a model year by the manufacturer.[10] In some cases, an automobile may have more than one manufacturer, as when a US vehicle producer arranges for a foreign vehicle producer to produce a vehicle in the United States.[11] In such instances, the statute contemplates that only one such company is considered the "manufacturer" of any particular vehicle for CAFE purposes. The producers could allocate those jointly produced vehicles between them for CAFE purposes as they see fit. This issue does not arise with respect to an import, since whoever brings the vehicles into the United States is the manufacturer. However, a foreign vehicle producer can allocate its exports across several importers if it is not in a control relationship with those importers.

2.17 Under CAFE, an importer is free to import vehicles from more than one foreign producer. In that case, that company would be the "manufacturer" of all the vehicles that it imports, which would be placed in that importing company's fleet. If a foreign producer were to import vehicles into the United States through two or more importers, the treatment of those vehicles under CAFE would depend on whether the importers are under common control. If, however, the importers were not under common control, their fleets would be treated separately under CAFE.

2.18 The importer is responsible for complying with both the CAFE standards and the gas guzzler tax with respect to a vehicle produced in a foreign country. Since foreign producers typically set up a US subsidiary to conduct the importation, the foreign producer may perform the actual testing necessary for compliance. If more than one independent entity imports vehicles made by a single foreign producer, each importer would separately be responsible to supply data and to comply with the gas guzzler and CAFE requirements. If there were civil penalties or taxes assessed, each importer would be required to make the appropriate payments separately. If the separate importers could agree, EPA would allow them to submit the same test data for fuel economy purposes. However, each importer would be separately responsible for meeting the minimum data requirements and might have to supply additional data if required.

2.19 For companies that are both importers and domestic manufacturers, average fuel economy is calculated separately for imported passenger automobiles and for those manufactured domestically. An automobile is considered to be manufactured domestically if at least 75 per cent of the manufacturer's costs are attributable to US materials or value added in the United States or Canada. Value is added by either the production or assembly of parts into vehicles. The CAFE

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[7] 15 U.S.C., §2002 (a)(1) and (b)

[8] *Id* at §2001(8)

[9] *Id* at §2001(9), (10)

[10] *Id* at §2003(c)

[11] *Id* at §2001(8)

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fuel economy test methodology, the average fuel economy requirements, and the penalties for non-compliance applied to a "domestic" fleet are identical to those applied to an "imported" fleet.

2.20 CAFE penalty letters are sent to the responsible manufacturer. In the case of a foreign producer that has set up a US subsidiary, the letter is sent to the US corporation or office bearing the name of the parent company. As noted above, this corporation is typically the importer of the vehicles. It is ordinarily also the same corporation that has submitted fuel economy reports.

2.21 EPCA required the US Environmental Protection Agency to determine the methodology for calculating average fuel economy, which is essentially the same as for the gas guzzler tax. EPA, by regulation, also specifies the data selection and averaging methods for the CAFE requirements. However, the timing of the calculations drives the content of the data in each, and makes them different. CAFE liability is based on an overall fleet average and need not be established before or during the model year as the gas guzzler tax requires. Model type calculations are also the basis for the CAFE calculation but they are performed at least twice for a model year. The first calculation is done prior to model introduction, and uses projected sales in the sales-weighted averaging. After the model year is over and after the manufacturer has completed testing of 90 per cent sales coverage by configuration, model type values are again calculated using actual sales and more extensive test data (covering at least 90 per cent of sales by configuration). Design changes and changes in projected sales may occur during the model year; if they create new subconfigurations, configurations or base levels, these are reflected in the CAFE calculation. Like the gas guzzler calculation, each model type for the CAFE will have a city fuel economy value and a highway fuel economy value. The resultant combined values for each model type are harmonically sales-weighted averaged to get the overall fleet, otherwise termed CAFE, value.

2.22 Thus, the differences between the gas guzzler calculation and the CAFE calculation include the use of projected sales for gas guzzler determination versus actual sales for CAFE, the requirement of one test per base level for gas guzzler determination versus 90 per cent fleet coverage for CAFE, and the different way running changes are reflected in the gas guzzler determinations versus the CAFE calculations. However, the averaging methodology used to establish model type fuel economy values is the same in each.

2.23 The CAFE value must at least reach the standard established in the legislation for that model year for compliance. If the manufacturer exceeds the requirement, it earns credits that may be carried forward or backward up to three years to help offset shortfalls in those years. If the manufacturer falls short of the requirement, it may still comply with the law by applying either carry forward credits from the prior three years, or, under a plan submitted to and approved by transportation authorities, "carry back" credits which it projects earning in the following three years. If the available credits are insufficient to fully offset the shortfall, the manufacturer is subject to civil penalties. The amount of the civil penalty is $5 multiplied by the amount of the shortfall, i.e. the number of vehicles produced by the manufacturer during the model year, multiplied by the number of tenths of a mile per gallon by which the manufacturer's fleet is below the requirement. For example, if the CAFE requirement is 27.5 mpg, and if a manufacturer's CAFE is 26.5 mpg, with 3.5 million automobiles in its domestic passenger automobile fleet, the penalty to the manufacturer will be $5 x 3.5 million x 10 = $175 million.

2.24 Also, under the CAFE law, manufacturers who manufacture, whether or not in the United States, fewer than 10,000 passenger automobiles may apply for exemption from the requirements. The exemption may only be granted if the Secretary of Transportation determines that the average fuel economy standard is more stringent than the maximum feasible average level which such a manufacturer can attain. The Secretary may not issue such exemptions, however,

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unless he/she establishes alternative average fuel economy standards for these automobiles manufactured by this manufacturer.[12]

III. MAIN ARGUMENTS

3.1 The **European Community** asked the Panel to find that:

(a) the United States luxury tax was inconsistent with Article III:2;

(b) the United States gas guzzler tax was inconsistent with Article III:2;

(c) the Corporate Average Fuel Economy law was inconsistent with Article III:2, III:4 and III:5 of the General Agreement; and

(d) the gas guzzler tax and the CAFE requirements could not be justified under the exceptions of Article XX(g) or of Article XX(d).

3.2 The **United States** requested that the Panel find that the CAFE requirements, and the gas guzzler and luxury tax provisions were consistent with the General Agreement.

A. Luxury Tax

(i) Article III:2

(a) *Charges or taxes in excess of those applied to domestic products*

3.3 The **European Community** (EC) argued that the luxury tax subjected most imported EC vehicles to a 10 per cent *ad valorem* tax, while exempting the core of US auto production. This led to the imposition of taxes on EC automobiles that exceeded the taxes on like or directly competitive American cars. Article III:2, first sentence, prohibited a contracting party from imposing taxes on imported automobiles that exceeded the taxes applied to like domestically produced vehicles. In addition, even if imported and domestic vehicles were deemed not to be "like" products for some reason, the second sentence of Article III:2 also prohibited a party from applying a tax that had the effect of protecting domestic auto manufacturers. The Notes ad Article III:2 clarified that measures that distort competition between "directly competitive" or substitutable products were deemed automatically to violate this requirement. As shown by the word "moreover", the second sentence of paragraph 2 represented a separate and distinct legal obligation. While it could be argued that violations of Article III:2, second sentence, could require an additional showing of protectionist effects, these were clearly assumed in Article III:2, first sentence, and arguably were also assumed for purposes of the second sentence as well, as soon as it was shown that "like" or "directly competitive" products were involved.

3.4 GATT had long recognized that the purpose of Article III was to ensure effective equality of competitive opportunity. Thus, according to the Panel on *United States - Section 337 of the Tariff Act of 1930*, Article III:2 first sentence, "protects expectations on the competitive relationship between imported and domestic products."[13] Such discrimination could take two forms. The most straightforward type of discrimination involved laws and regulations that singled out imports on the basis of origin for less favourable tax or regulatory treatment. In addition,

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[12]*Id* at §2002, (c)(1)

[13]Panel report adopted on 11 November 1989, BISD 36S/345, para. 5.13.

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GATT had long recognized that tax and regulatory measures could discriminate *de facto* if they had the effect of imposing disproportionate burdens on imported merchandise or served to protect domestic industries in violation of Article III:2 or other provisions of Article III. Thus, the Panel on *Japan-Customs duties, taxes and labelling practices on imported wines and alcoholic beverages*[14] clearly established that a tax classification system that was facially neutral could violate Article III:2 if it had a disproportionate impact on imports, the tax categories did not correspond to objective product differences, and the higher taxes on imports could not be justified as part of a general trade-neutral system of taxation that affected all products equally.

3.5 All automobiles represented a single like product. Therefore, by carving out an artificial tax category for automobiles sold for $30,000 and above, which hit European imports with a punitive tax, while exempting almost all US cars or subjected them to a minimal tax, the United States had violated Article III:2, first sentence. The clear effect of the US tax was to subject European imports to a tax while like domestic vehicles escaped. Furthermore, even if for some reason cars sold for $30,000 were deemed to represent a distinct like product, the US tax still violated Article III:2, second sentence, since the $30,000 threshold was designed to protect US automobile production by exempting US cars from the tax.

3.6 The threshold had no basis in rational tax policy or objective product differences. While GATT prohibited a contracting party from applying excessive taxes to imports, this did not mean that all like products must be subjected to exactly the same tax. In determining whether tax or regulatory distinctions between "like" products were legitimate, GATT had looked to whether the tax category corresponded to objective product differences and formed part of a broader trade-neutral system of taxation. Thus, in *Japan- Alcoholic beverages*, the Panel struck down Japan's system of taxing alcoholic beverages because the Panel was unable to find that the differences as to the applicability and non-taxable thresholds of the ad valorem taxes were based on corresponding objective product differences (e.g. alcohol content) and formed part of a general system of internal taxation equally applied in a trade neutral manner to all like or directly competitive liquors. The US luxury tax failed this simple test. The tax did not correspond to objective product differences; there was no meaningful distinction between cars priced above and below the threshold, except that a disproportionably large number of those sold for more than $30,000 were European. Furthermore, the tax was not part of a general system of excise taxes. While some US vehicles were subject to the tax, the prices of most United States "luxury" car models barely exceeded the $30,000 threshold, so they paid a minimal tax. Consequently, European manufacturers accounted for a disproportionate share of the revenues generated.

3.7 The **United States** stated that the luxury tax was a facially neutral measure that applied equally to imported and domestic automobiles, i.e. a European car sold above $30,000 was subject to the same tax as a domestic car sold for the same price. The General Agreement was concerned with equal treatment, and did not guarantee trade flows. Where, as here, a neutral tax applied, i.e. treatment as such was equivalent, the issue under Article III was whether the tax was applied so as to afford protection to domestic production, and it was clear from the legitimate purpose of the tax, the objectivity of its criterion (price) and its application, which did not impair equal competitive opportunities available to imports and domestic products, that this was not the case here. Less than 9 per cent of all imports were subject to the tax, which was intended to tax affluent Americans who could afford the most expensive vehicles, and to counteract the low rate of savings in this tax bracket. Any US tax on the value of a vehicle was bound to "disproportionately" affect imports from certain European manufacturers because their vehicles were on average much more expensive than US or Japanese vehicles. The General Agreement did not preclude parties from taxing on a progressive basis simply because imports from one

[14]Panel report adopted on 10 November 1987, BISD 34S/83, para. 3.9(b).

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contracting party happened to be more expensive. Moreover, the tax did not impose sharply higher tax liability or create a distinct category for unfavourable treatment, since it applied on an ad valorem basis and only to the portion of the actual transaction price of an automobile above $30,000. Little tax was paid by vehicles just above the threshold compared to those just below the threshold.

3.8 The **European Community** explained that it was not discussing trade volumes nor relying on the fact that EC trade in these cars had diminished. For example, for 1992, its critique was based on differential impact analysis which rested on three measurements of discrimination. The first was the amount of tax paid compared to the market share: European cars constituted about 3.3 per cent of the market but paid almost 70 per cent of the total luxury tax yield. Second, 41.2 per cent of European imported cars were subject to the tax compared to 2 per cent of US-produced cars (and 5.7 per cent for Japanese imports). Third, the share of European imported cars in the total number of cars subject to the tax was 32 per cent compared to the overall market share of European cars in the United States, 3.3 per cent. That meant that the tax hit ten times as many cars as would be expected based on overall European import market share, while US cars were hit less than half as much as would be expected based on their overall market share.

3.9 Evidence of the discriminatory impact of the luxury tax was shown in a study prepared by the Luckey Consulting Group, Inc.[15] The methodology of the study was based on the assumption that it was a well established fact that few, if any, consumers paid the manufacturer's suggested retail price (MSRP) when purchasing a new car. Instead, consumers would negotiate a price with the dealer which usually would fall between the MSRP and the price at which the dealer had purchased the car from the manufacturer. The report estimated consumers' actual transaction price for vehicles by discounting MSRP by 10 per cent on retail sales and 15 per cent for fleet sales. In calculating estimated retail transaction price, the study included any gas guzzler tax that had to be paid on the vehicle because US law included gas guzzler tax into the base on which luxury tax was calculated.

3.10 Detailed statistics from the Luckey study showed that in 1990, the year in which the luxury tax was adopted, US car production totalled 6,563,527 vehicles. Of these, only 17,300 sold for more than $30,000. Thus, only 0.3 per cent of US auto production was potentially subject to the luxury tax. In contrast, of the 395,958 European vehicles sold in the US market in 1990, 147,253 sold for more than $30,000. Thus, 37.2 per cent of European automobiles sold were potentially subject to the 10 per cent *ad valorem* tax, which would have generated more than 87 per cent of all luxury tax revenue. The tax went into effect as from 1 January 1991. In 1991, US producers had sold 5,906,799 cars in the United States, of which 43,051, or 0.7 per cent of US production, was subject to the luxury tax. Meanwhile, European producers sold 283,755 cars in the US market, of which 109,206 or 38.5 per cent, were subject to the luxury tax.

3.11 Moreover, the EC argued that in 1992 the luxury tax affected 109,309 of 265,183 imported European automobiles sold in the United States, or 41.2 per cent. In contrast, it applied to 120,094 of the 5,888,680 automobiles manufactured in the United States, or 2.0 per cent. The discriminatory effects of the luxury tax were even more pronounced if the relative tax burdens were considered. While US vehicles were subject to the tax, the majority sold by the Big Three sold in the $30,000-$35,000 range and were subject to a minimal tax. Thus, the average tax for most US models subject to the tax in 1992 was relatively small: Buick ($150), Cadillac ($373), Chevrolet ($307), and Lincoln ($150). As a result, the average luxury tax for a US-built car was only $266 in 1992. But because European luxury cars sold for substantially higher prices, they

[15] The Luckey Consulting Group, Inc., "U.S. Luxury New Car Tax, Gas-Guzzler Tax, & CAFE Discriminatory Impacts", Final Report, Woodcliff Lake, New Jersey, September 1993.

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had on average been subject to much higher luxury taxes: Mercedes ($2,685), BMW ($1,003), Porsche ($3,023), Ferrari ($12,842), Rolls-Royce ($13,300), Bentley ($14,940), Maserati ($1,370), Lotus ($1,493), Lamborghini ($18,385), and Aston Martin ($17,294). Consequently, the average luxury tax of European-built autos in 1992 was $1,912. (The average tax on a Japanese "luxury" car was less, $545, but still substantially higher than on Big Three vehicles.)

3.12 The combination of large numbers of European cars subject to the tax and a much higher per-vehicle tax burden meant that European manufacturers accounted for a disproportionate share of luxury tax revenues. For example, according to the Luckey Study, of $300.6 million owed in luxury taxes in 1992, European cars, which accounted for only 3.29 per cent of the autos sold in the United States, had 69.54 per cent ($209 million) of luxury tax paid on them. Only 10.63 per cent ($32 million) of the luxury tax was paid on Big Three cars, and 19.83 per cent ($59.6 million) was paid on Japanese cars. Similarly for 1991, of $254 million in luxury taxes, 76.82 per cent ($195.1 million) was paid on European cars, despite constituting less than 4% of total US sales. Only 7.15 per cent ($18.2 million) and 16.03 per cent ($40.7 million) was paid on US and Japanese origin vehicles, respectively. Cumulatively, this meant that for 1991 and 1992, of $554.6 million paid in luxury tax, 72.9 per cent ($404.1 million) was due on European cars, while only 9.0 per cent ($50.2 million) and 18.1 per cent ($100.3 million) were due on US and Japanese cars, respectively.

3.13 The **United States** disagreed with the calculations and conclusions drawn by the EC regarding the number of autos subject to the luxury tax. The fact that the United States Government did not maintain records or actual data of which cars had been subject to the tax undermined the EC's legal theory that numbers alone could establish an inconsistency with Article III. Since the General Agreement did not preclude parties from taxing on a progressive basis, the question before the panel was whether the $30,000 threshold was objective and based on legitimate (non-protectionist) social policies and did not offer protection to domestic production. In its examination of actual sales affected by the tax, the United States focused on the number of vehicles by origin just above and just below the threshold (between $25,000 and $35,000), which showed substantial numbers of imports and domestic vehicles, respectively. This showed that the threshold itself had not been applied so as to protect domestic production.

3.14 Given that there were no actual data of retail price and luxury tax paid by car make available, retail prices (and the amount of luxury tax paid) had to be estimated by combining various sources of data and applying assumptions to that data. The statistics presented in the Luckey study, although based on the same sales data that the United States used in its data calculations, were based on wrong assumptions in calculating the retail prices from the Manufacturer's Suggested Retail Price (MSRP). The assumption made by the Luckey study, that all cars were sold at 10 per cent below the manufacturer's suggested retail price, misrepresented the reality. Indeed, the "disproportionate impact" shown by these figures could have varied considerably if retail prices had varied slightly in many cases. Several factors influenced the final transaction price of any auto sale. These included regional factors, options selected, transportation, time of year and the relative negotiating skills and economic positions of purchaser and seller. Besides MSRP, two factors were the most significant in determining the transaction price of a vehicle. The first was the addition of options into the price estimate. Unlike European cars, the price of most American luxury models did not include certain luxury features, such as leather seats, which were selected for many cars purchased. If the cost of only a few such features were added to US luxury vehicles before discounting the 10 per cent assumed by the Luckey study, for example, many of the vehicles would fall within the range of automobiles subject to the luxury tax. The second was the negotiating process and any discount provided by the dealer to the consumer.

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3.15 In any event, assigning an average discount to automobile sales in the United States was an inaccurate way to measure the distribution of sales, since, as shown by consumer surveys, sales took place across a broad range of prices. Not only did the averaging approach produce a dramatic inaccuracy with respect to all vehicles above and below the threshold; assigning one price to all sales of a vehicle type was singularly inappropriate for predicting the impact of a threshold tax. A model that incorporated the existence of variation in automobile transaction pricing would be required to most accurately estimate the actual taxes paid by consumers. Short of such a model, a market analysis of the average transaction price, based on empirical data, was a useful, though limited, means to estimate transaction price for the purpose of illustrating the level of competition between domestic and foreign automobiles above and below the threshold, respectively.

3.16 In response to the questions submitted by the panel and in order to support its view regarding the existence of intense competition in the $25,000-35,000 price range, the United States calculated a discount rate based on the monthly Consumer Price Index survey data from the US Bureau of Labour Statistics (BLS). BLS collected data on retail transaction pricing of automobiles as part of its calculation of monthly consumer price indices in the US economy. Each record in the BLS auto sample reflected an average sale from several sales of a specific auto during a given month and included auto make and classification (i.e. compact, full sized, luxury, etc.), average base price (MSRP), average options charges, average preparation and transport charges and average dealer markdown. From these data, average transaction price was calculated which provided a picture of actual transactions in the US market, and established a basis on which to analyze the relationship between MSRP and actual transaction prices.

3.17 These calculations showed that the average adjustment from base price to transaction price varied between .19 per cent to -6.02 per cent. This result discredited the Luckey study's assumption of a 10 per cent markdown from base MSRP. When options, transport and prep charges and dealer markdown were taken into account, the average downward adjustment (from base price) for retail sales was significantly less than 10 per cent. Although similar data were unavailable for fleet sales, the US information suggested that Luckey's 15 per cent discount was underestimated. Accordingly, the United States estimated that fleet sales were 22 per cent below MSRP.

3.18 The results of the BLS based analysis revealed the level of competition among domestic and imported automobiles sold at prices between $20,000 and $40,000. These calculations resulted in a different picture of the number and relative proportion of cars by origin just below and above the $30,000 threshold than that presented by the EC. For example, in 1991, in this range, there were 317 per cent more (131,270) US domestic autos subject to the luxury tax than European autos (41,312) in that range. Also in that year and range, 73.5 per cent of European vehicles (114,851), and 80.6 per cent of US domestic automobiles (545,268) were not subject to the luxury tax. In 1992, in the $20,000-$40,000 range, there were 618 per cent more (247,431) US domestic autos subject to the luxury tax than European autos (40,019). Also in that year and range, 76.9 per cent of European cars (132,924) and 57.4 per cent of US domestic cars (333,333) were not subject to the luxury tax (accordingly, 42.6 per cent of US domestic autos in the $20,000 to $40,000 price range were subject to the luxury tax). Therefore, it could hardly be argued that the tax was designed to protect American vehicles below $30,000 from competition with such European luxury cars.

3.19 Moreover, there was no question of discrimination between the tax's applicability to European cars above $60,000 (where there was no domestic or other foreign competition) on the one hand, and domestic vehicles below $30,000, not subject to the tax, on the other. Consumers wishing to buy a $60,000 automobile were not likely to switch to an automobile priced at less than

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$30,000 just to avoid the luxury tax; consumers in the United States tended to select vehicles from those within a price range of about 15 per cent.

3.20 The **European Community** stated that its analysis showed that many luxury features appeared as no-cost options, contradicting the US assertion on the installation rates of these options. The US analysis of options, in effect, assumed that each and every purchaser of a Buick Regatta, Cadillac De Ville, Cadillac Fleetwood, Cadillac Brougham, Cadillac Eldorado, Cadillac Seville, Chevrolet Corvette, and Lincoln Town Car purchased three options at full price - leather seats, stereo upgrade, and sunroof. This was valid only if the Panel accepted several assumptions. First, the United States failed to take into account fleet sales, which commanded much higher discounts and accounted for one-third of Cadillac's sales and over one-half of Lincoln's sales. Second, the United States claim that each of the models at issue had a 100 per cent installation rate for the three options was belied by publicly available data from reliable trade publications such as "Automotive News". Certain listed options were not even available for some models. Third, options were subject to extensive discounting in the United States and some were even given without charge. Finally, the United States did not include special sales rebates that were in effect for much of 1991-92 to offset weak automotive sales during the US recession. Although the Luckey study did not specifically examine these rebates (because, in Dr. Luckey's view, the rebates were unnecessary to establish discrimination and would have required extensive additional research and calculations), they allowed dealers to sell specific models for an even greater reduction from MSRP than normal discounting practices, which were covered by the 10 percent assumption.

3.21 The EC disagreed with the applicability of the BLS data supplied by the United States. This data, as the United States admitted, was based on an extremely small sampling and "therefore lacks the detail necessary to the conduct of a thorough analysis." As a result, the BLS data yielded results that did not accord with established fact. The unreasonably small discount assumption used by BLS,which understated the average discount percentage on vehicle sales, and thus overstated both the number of cars on which tax was owing and the total amount of tax due, resulted in presumed luxury tax collections that exceeded by more than 22 per cent the actual collections reported by the US Internal Revenue Service for 1991 and 1992. By contrast, the Luckey study approximated IRS collections to within less than 3 per cent. Moreover, any increase in the US discount percentage would serve primarily to exclude US cars from luxury tax, since the cars clustered just above the $30,000 threshold were overwhelmingly of American origin.

3.22 In support of this position, the EC submitted two affidavits concerning American "luxury" car sales. The first was from Thomas Webb, the Chief Economist for the National Automobile Dealers Association (NADA). NADA was the largest automobile trade association in the US and represented more than 19,000 US automobile dealerships. In contrast to the partial data provided from the BLS, Mr. Webb provided complete data collected directly from dealers with respect to sales of Cadillacs, the largest selling American-made "luxury" car. Nearly all US Cadillac dealers were members of NADA. Based on this information, Mr. Webb concluded that the average discounts from MSRPs for Cadillacs in 1991 and 1992 ranged from 8.4 percent to 12.0 per cent. He further concluded that it was factually inaccurate to claim that large numbers of Cadillac models were subject to the luxury tax or that the Cadillac models most in dispute (the "base" models of De Ville, Eldorado, and Fleetwood with the lowest MSRPs and highest volume sales) sold at average transaction prices above $30,000.

3.23 Mr. Webb's claims were supported by the affidavit of Dr. Susan Jacobs, an automotive industry consultant. Dr. Jacobs concluded that the BLS data significantly understated the discount at which luxury cars sold from MSRP; her research had consistently yielded an average discount

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for US "luxury" cars that was more than double the 4.09 per cent claimed by the United States. She concluded that an unreasonably small discount assumption led the United States to overstate by at least 50 per cent the numbers of US cars that paid luxury tax in 1991 and 1992.

3.24 The US approach contained a number of evident flaws. First, in aggregating BLS field data, the United States appeared to have averaged together models with different MSRPs, thus overstating the average transactions prices with respect to the lowest-priced or base models, those with MSRPs just above the $30,000 threshold. In support of this claim, virtually none of the "average base prices" set forth by the United States were actually MSRPs for American vehicles. Second, the US data omitted customer cash rebates - ranging as high as $3,000 per car - from American computation of transaction price. Once these direct rebates were taken into account, the number of American cars potentially subject to the tax would fall dramatically, approximating the level set forth in the Luckey study with respect to both cars subject to the tax and amount of tax due. Finally, when US claims regarding "average" installed options were adjusted to reflect actual option installation figures, the totals put forward by the United States also fell dramatically, even if all other aspects of the US claims were accepted as true.

3.25 Furthermore, the fact that a few American cars were also taxed was not a defense under Article III:2. In the Panel on *Japan - Alcoholic beverages*, Japan argued that its liquor tax system was non-discriminatory because "there was no category where only imported products were subject to taxation".[16] However, the Panel concluded that the existence of certain domestic products in a tax category was insufficient *per se* to establish non-discrimination under Article III. Instead, the Panel examined whether imported whiskies/brandies had been singled out for a disproportionate tax burden. It concluded that the Japanese system violated Article III because most imported whiskies/brandies were in product categories subject to the highest tax rates.[17]

3.26 The **United States** considered the EC's citation of the *Japan - Alcoholic beverages* panel inapposite, since that case involved the creation of categories based on no discernible objective criteria and no defensible policy purpose. The United States did not agree that a trade neutral tax, based on legitimate policy purpose, which did not afford protection to domestic production, could be inconsistent with Article III on the basis that it had a "disproportionate impact" on exports from a few manufacturers of a particular contracting party.

3.27 GATT panel findings over the years had confirmed that the first sentence of Article III:2 required that imports be provided equivalent competitive opportunities,it did not guarantee trade flows. The second sentence, and the Note Ad Article III, addressed the situation where the targeting of imports was more subtle, for example, a country's levying of a high tax on peaches, in which it had no substantial domestic production, in order to protect domestic pears, which were directly competitive products. In cases where GATT panels had found that applying separate tax rates for similar imports and domestic products was inconsistent with the first sentence of Article III:2, it had been observed that Article III's central concern was the targeting of imports as such for differential treatment. No panel, including those cited by the EC in this case, had found a trade-neutral tax law inconsistent with Article III based solely on the incidence of the tax on imports by manufacturers of one particular contracting party, or that happened to have a "disproportionate impact" on certain imports. Rarely, if ever, were all manufacturers and their production equally situated. Accordingly it would be rare for all goods to be equally affected by a government's measure. Yet under the EC's approach, whenever a measure affected some manufacturer's products in another country more than domestic products, the measure would be

[16]BISD 34S/83, para. 3.10(a).
[17]*Id* at para. 5.9(a).

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inconsistent with the General Agreement. This approach did not make sense, nor was it consistent with the drafting history or practice of the General Agreement.

3.28 Indeed, the Report of the Panel on *United States - Taxes on petroleum and certain imported substances ("Superfund")* stated that "Article III:2, first sentence, obliges contracting parties to establish certain competitive conditions for imported products in relation to domestic products. Unlike some other provisions in the General Agreement, it does not refer to trade effects."[18] Similarly, the Panel on *United States - Measures affecting alcoholic and malt beverages* "considered that Article III:2 protects competitive conditions between imported and domestic products but does not protect expectations on export volume".[19] Accordingly, the mere proportional incidence on imports of a facially neutral tax (i.e. "trade effects") was insufficient to establish discrimination under Article III.

3.29 The **European Community** argued that the US legal argument regarding "trade effects" was based on a misapplication of the holding of the Panel on *United States - Taxes on petroleum and certain imported substances*. This Panel had flatly rejected a US claim that a discriminatory tax that violated Article III could be permitted if it caused only minimal harm to imports.[20] Under GATT, the fact that a discriminatory measure caused little or no trade damage was not a defense for a violation of Article III. The issue before this Panel was whether the luxury tax was discriminatory and thus violated Article III:2; the holding of this Panel with respect to injury was irrelevant to that issue since it related to nullification or impairment once a violation of GATT had already been found.

3.30 GATT had long recognized that Article III encompassed both *de jure* and *de facto* discrimination. A discriminatory internal measure was not outside the bounds of GATT rules and obligations regarding non-discrimination simply because it appeared in the guise of achieving a legitimate policy objective and did not explicitly mention imports "as such". Otherwise, Article III (and GATT itself) would become an empty framework, since tax and regulatory authorities would be free to devise ostensibly neutral internal measures which would have the effect of protecting domestic industries, imposing higher, punitive taxes on imports, or penalizing foreign goods with unequal and unwarranted regulatory burdens.

3.31 In assessing Article III's guarantee of "equality of competitive opportunity", GATT panels had traditionally examined both the purpose and effect of internal taxes and measures challenged under Article III. Evidence of disproportionate impact was highly probative of whether there was *de facto* discrimination against imports in violation of Article III:2. Unless GATT examined the actual impact of a tax, Article III could be circumvented through facially neutral taxes, like the luxury tax, that had a disproportionate and unfair burden on imports.

3.32 The **United States** noted that the drafting history and the purpose of Article III made clear that GATT contracting parties retained the right to promulgate taxes or regulations that created distinct categories among similar products, or encouraged the manufacture of goods according to particular specifications, but did not on their face discriminate against imports. In the vast majority of cases, once it was established that a measure provided national treatment on its face, the measure would be presumed consistent with Article III:2 unless it appeared that the very regulatory categories created were so exceptional as to suggest the tax was being applied so as to afford protection to domestic production. This would run against the purpose of Article III, as stated in its first paragraph and made mandatory in the second sentence of Article III:2. This had

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[18]Panel report adopted on 17 June 1987, BISD 34S/136, para. 5.1.9.

[19]Panel report adopted on 19 June 1992, BISD 39S/206, para. 5.6.

[20]BISD 34S/136, para. 5.1.9.

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been the case in the Japan and United States *Alcoholic beverages* disputes, where the panels in most instances concluded that the particular categories or criteria for applying the tax were so unusual that they appeared to have been created so as to afford domestic production. In such cases this inquiry was not satisfied by an examination of the incidence of the measure upon certain importers or manufacturers. A "disproportionate impact" on imports may be helpful in determining if the selection of the particular categories was designed to afford protection to domestic production, but other facts establishing such protection must also be present. For example, in the *United States - Alcoholic beverages* case, the panel gave very little weight to the fact that the market for the category of beer (low alcohol) that was taxed at lower rates was served entirely by domestic companies, and noted that creation of different categories (and accordingly, differential treatment) had not in fact had a protective effect.

3.33 If the categories created were based on objective criteria that did not impair equal competitive opportunities available to competing imports and domestic products, and were based on legitimate social policies, it could be assumed that the measure was not applied to afford protection to domestic production. If a tax adversely affected only a small proportion of imports, while the balance of imports were unaffected (the case here), there also was a strong indication that the measure was not applied so as to afford protection to domestic production. If, proportionally, only a few imports were subject to the tax, evidence of the tax as protecting domestic production from imports was negligible or non-existent. In the case of the luxury tax (as well as the gas guzzler tax) the proportion of imports subject to the tax was minimal (less than 9 per cent), and the EC could not show that the tax was capable of protecting domestic production.

3.34 Also, under the EC's interpretation of Article III, any trade-neutral measure, such as an environmental law or a safety standard, could be inconsistent with the General Agreement if it "disproportionately affected" imports from a particular contracting party, even if those imports presented a "disproportionate" part of the environmental or safety problem, or the "disproportionate effect" resulted from conscious decisions by exporters based on their own economic interests. Although the United States understood that the EC did not consider measures that had a disproportionate impact on imported goods *per se* inconsistent with Article III, it considered the EC's characterization, that "disproportionate impact" was "highly probative" of discrimination under Article III, unfounded.

3.35 While the GATT aimed at removing unfair trade barriers, contracting parties had retained almost complete freedom with respect to domestic policies that did not distinguish between the origin or destination of goods. The EC's view, that virtually any *de jure* neutral measure, inconvenient to part of one party's industry, presented *de facto* discrimination, had no support in either the GATT's drafting history or panel reports. Even the EC's own jurisprudence offered no support for such a view. The purpose of Article III, stated in its first paragraph, was to discourage only those measures that were applied "so as" to afford protection to domestic production; the term "so as" made the *intended* effect critical. If the EC could not show, in addition to disproportionate impact, that the measures were inherently discriminatory, then it would fail to establish discrimination under Article III.

3.36 Further, the EC's arguments re-visited issues that were raised when the Agreement on Technical Barriers to Trade (TBT) was being negotiated during the Tokyo Round. Standards were widely recognized as serving important public policy objectives, even though they often had a more adverse effect on imports than on domestic products. Recognizing that standards by their nature often created obstacles to international trade, the drafters of the TBT Agreement sought to discipline only those standards that created an "unnecessary" obstacle to international trade. Had the consensus been that Article III already disciplined standards based only on their "adverse"

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effect on some imports, no separate agreement to supplement the General Agreement would have been necessary.

3.37 Article III permitted *de jure* neutral laws to differentiate between products for legitimate policy purposes, including to harmonize national standards, to force technological innovation for the purpose of fuel conservation or other economic policy objectives, to tax on a progressive basis, to protect the environment and to avoid the accumulation of wastes. In fact, under the TBT Agreement, contracting parties remained free to prohibit imports of products that did not comply with their technical regulations. This would create a far more "disproportionate" impact on imports than the measures at issue in this dispute, yet it had not been suggested that Article III would render all such technical regulations inconsistent with the General Agreement.

3.38 The **European Community** argued that if Article III protected only against the most flagrant and blatant forms of discrimination, room increased for insidious protectionist tampering with the value of tariff bindings. The requirement that the effect of a discriminatory measure be protectionist would only come into play if the measure involved less favourable treatment of "directly competitive" products under Article III:2, second sentence. But even then the words "so as" or "de manière à" in Article III:1, to which the second sentence of Article III:2 referred, did not demonstrate a restriction to protectionist *inten*t. These were neutral terms both in French and in English and confirmed an effects approach to discrimination. The US position, that an internal tax or measure must explicitly single out imports "as such" for differential treatment and for a violation of Article III, was an extremely limited interpretation of Article III:2. In the *Japan - Alcoholic beverages* case, Japan's system of taxing alcoholic beverages applied to both domestic and imported beverages and never targeted imports "as such", nor did it directly exempt domestic goods from higher taxes. Instead, this was accomplished through the artful drafting of narrow or exclusionary tax categories, using devices such as (1) price thresholds that were triggered by most imported liquors, but very few domestically produced liquors; (2) taxation by extract content that applied to imported European liqueurs, but allowed specially formulated Japanese liqueurs to escape into lower tax categories; and (3) grading requirements that tended to put imports into categories subject to dramatically higher tax rates than domestically produced whisky and brandy. The Panel recognized that such *de facto* discrimination violated GATT.

3.39 Further, the United States arguments on the TBT Code were without merit in a case on tax discrimination. The TBT Agreement, even if the US view of it was correct - *quod non* - represented an attempt to develop *one* special problem under Article III:4 of the GATT. Obviously contracting parties to the GATT had not considered it necessary to further develop the very clear provisions of Article III:2 on tax discrimination. Hence no conclusions for the interpretation of Article III:2 could be drawn from the existence of the TBT Agreement.

3.40 Similarly in *Canada - Import, distribution, and sale of alcoholic drinks by provincial marketing agencies*[21], the Panel considered whether minimum prices for imported and domestic beer that were maintained by some provinces violated Article III:4. Canada sought to justify the minimum price system as part of a "social policy objective of the liquor boards to ensure responsible use of alcohol" - a facially neutral public policy goal. However, the Panel stated that "minimum prices applied equally to imported and domestic beer did not necessarily accord equal conditions of competition to imported and domestic beer. Whenever they prevented imported beer from being supplied at a price below that of domestic beer, they accorded treatment to imported beer less favourable than that accorded domestic beer.[22] Thus, the Panel held that a measure did not need to target imports "as such" to violate Article III.

[21]Panel report adopted on 18 February 1992, BISD 39S/27.

[22]*Id* at para. 5.30.

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3.41 Recently, the Panel on *United States - Alcoholic beverages*, had considered whether US restrictions on the points of sale, distribution, and labelling of high-alcohol content beer violated Article III. In concluding that the distinction between high- and low-alcohol content beer was non-discriminatory, the Panel noted that although various US states defined low-alcohol content beer in different ways, "there was no evidence submitted to the Panel that the choice of the particular level had the *purpose or effect* of affording protection to domestic production".[23] This Panel had also recognized that Article III could be violated by deliberate and purposeful measures, but that a violation could also be inferred from the discriminatory or protective effects of a measure.

3.42 The facial neutrality of a law was no defense under Article III if the effect was to discriminate against imports or accord less favourable treatment to imported merchandise. The $30,000 luxury tax threshold served no apparent purpose except to segregate numerous imported and mostly European cars for less favourable tax treatment. The perpetuation of such discrimination was illustrated by recent action to index the threshold to $32,000 under the Omnibus Budget Reconciliation Act of 1993, which would exclude most (at least an additional 81,000) American cars subject to the tax, while exempting relatively few European vehicles, thus exacerbating the discriminatory effect of the tax. Under EC figures, indexation exempted 68 per cent of US cars previously subject to the tax. (Even under BLS data, 58.2 per cent of US cars otherwise subject to the luxury tax would escape through indexation).

3.43 The **United States** argued that the reports cited by the EC with respect to Article III:2 in fact supported the view that a facially neutral measure must be shown to be applied so as to afford protection to domestic production, and that the nature of the category itself must be examined with this in mind (in addition to any actual protective effect). In the *United States - Alcoholic beverages* case, the panel considered a special tax category for wine from a variety of grape that could only be grown in limited areas to reflect an "exceptional" basis for a distinction, and noted that the United States had not provided the panel with evidence of any non-protectionist policy objectives underlying it. In the *Japan - Alcoholic beverages* case, the panel concluded that only protectionist goals could underlie the tax system's distinction on the basis of the amount of a non-volatile ingredient necessary to create the traditional formula of a liqueur, or the exclusion from the lower tax rate of a spirit based on the very filtering method that gave it its product identity (vodka). Moreover, the panel also noted that the classification of liquors into "grades" was not based exclusively on price, but on subjective criteria, such as the authorities' perception of a drink as "high quality" or appealing to lower classes; in practice, whether the authorities perceived a product to be "high quality" was determined by its "Western" origin. The differential taxation methods applied to each of these grades thus amounted to differential treatment accorded to imports. The price thresholds within each particular grade were not in themselves at issue in that dispute; the panel did not reject a graduated ad valorem tax applied to all products on the value above a price threshold, like the US luxury tax on automobiles. The price of a product was the basis upon which ad valorem tariff rates were applied, and undoubtedly the most objective criterion on which to apply a tax in a progressive manner. As reviewed in the discussions following this section, the $30,000 threshold itself was based on a balance between revenue-raising and progressivity.

3.44 Further, the Omnibus Budget Reconciliation Act of 1993 was enacted after the establishment of this Panel and was not within its terms of reference. Moreover, the EC's invocation of this Act could not serve to impute retroactively a protectionist purpose to the luxury tax. OBRA 1993 repealed the luxury excise tax imposed on boats, aircraft, jewelry, and furs. In addition, the tax on passenger vehicles was modified by indexing the $30,000 threshold for

[23]BISD 39S/206, para. 5.75.

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inflation occurring after 1990, to take effect in 1994. The Senate Finance Committee had explained that indexing was necessary to ensure that only the higher-priced segment of the automobile market was subject to tax. The Committee specifically dismissed the claims that raising the threshold discriminated against imports.[24] Moreover, even if indexing would prevent inflation from pushing more domestic models under the luxury tax, it was equally true that it would prevent a greater proportion of EC imports from being taxed.

3.45 Given that the tax set forth an objective, unexceptional criterion, based on a GATT-consistent objective, the EC had not shown that it was applied so as to afford protection to domestic production. Moreover, data on the US luxury market in fact showed that no such protection had been provided. In response to questions by the Panel regarding the effect on sales of the measures, the EC had claimed that the luxury tax had caused drastic results for the industry. However, these claims were unfounded; any difficulties for EC manufacturers in the US market began before imposition of the luxury tax. Since 1985 there had been a shift in sales from European to Japanese brands. European manufacturers greatly underestimated the intrinsic build and finish quality, as well as the quality of the driving characteristics, of the Japanese luxury brands; they failed to recognize that the American customer had become more sophisticated and no longer equated high price with high value; and they failed to anticipate, and developed no strategy to counteract, the rapidly acquired, excellent reputation of Japanese luxury automobiles. Loss of market share by European luxury car manufacturers to Japanese manufacturers, subject to the same tax, was well known and uncontested. The flourishing of competing Japanese automobiles, subject to the same competitive conditions as the complaining European manufacturers, showed that the luxury tax could hardly be considered to be affording protection to domestic production.

3.46 Further, the overall US market had declined between 1986 and 1991 and was essentially flat in 1992, reflecting pervasive difficulties in the American economy. In addition to there being fewer customers, such contractions typically caused remaining buyers to seek greater value for their expenditures, even in the luxury categories. Japanese brands, until the 1993 appreciation of the yen, had overwhelmingly represented the better value. In mid-1993, sales of Japanese luxury brands began to falter and several European makers began cutting prices, offering better lease and finance terms, or increasing product content without increasing retail prices to take advantage of the appreciation of the dollar against European currencies and depreciation against the yen. The present market appeared to be shifting in favour of European exports. Through August 1993, sales of European luxury brands reached 170,952, up 4.5 per cent over the same previous period. This generated a 23.8 per cent share of the total luxury market, compared to 22.2 per cent previously. Japanese brands dropped to 173,619 and their market share dropped to 24.1 per cent from 24.3 per cent previously. Sales of American brands dropped to 374,863 units and their share declined from 53.5 per cent to 52.1 per cent.

3.47 In sum, if a measure was *de jure* neutral, this was generally the end of the enquiry. Only when the complaining party could show that the criteria were intrinsically protectionist (applied in a manner to afford protection to domestic production) would they be inconsistent with Article III. The fact that the measure had in fact not protected domestic production had already been established. As discussed further below, the objectivity of the criterion of the tax and the legitimacy of its purpose showed that its intent was not to afford protection to domestic production (i.e. it was not applied "so as" to afford protection).

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[24]Staff of Senate Committee on Finance, 103rd Congress, 1st Session, Fiscal Year 1994 Budget Reconciliation Recommendations of the Committee on Finance 86 (Comm. Print 1993).

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3.48 The **European Community** countered that the OBRA 1993 illustrated a continuing pattern of adjusting the tax to minimize its impact on US manufacturers and shift the tax burden to imports in violation of Article III:2, first and second sentences, and Article III:1. While the United States claimed that the indexing amendment was beyond the Panel's authority, its consideration as evidence was plainly within the Panel's terms of reference. Further, there was nothing in GATT practice to support the proposition that relevant evidence obtained during the course of a proceeding was outside the Panel's consideration. Adoption of the proposed US rule would greatly increase the burden on GATT, since a Panel would have to be reconstituted each time such evidence was obtained.

(b) Like product

3.49 The **European Community** noted that Article III:2 involved two separate and distinct legal obligations. The first sentence set out a *per se* rule that imported goods could not be subjected to taxes in excess of those imposed on domestic like products. Such discrimination was flatly prohibited, and protectionist effects need not be shown. Instead, such protectionist effects appeared to be assumed from the fact that "like" imported goods were being subjected to less favourable tax treatment. Thus, if cars above and below the $30,000 threshold were like "products", and the $30,000 threshold had the effect of subjecting imported European cars to higher taxes than like American vehicles, then the luxury tax represented a per se violation of Article III:2, first sentence. The second sentence contained a separate requirement that imports could not be taxed in a different and less favourable manner that had the effect of affording protection to domestic production. The Notes ad Article III clarified that the second sentence covered taxes that applied to imported goods, but exempted "directly competitive" domestic products. Thus, even if GATT deemed cars priced above and below the $30,000 threshold to be distinct like products, such vehicles still competed directly for purposes of Article III:2, second sentence, and the Notes Ad Article III:2. As a result, the luxury tax also violated Article III:2, second sentence, because it protected directly competitive American cars which sold for less than $30,000 ($32,000 with indexing).

3.50 In applying the term "like product" in the context of Article III, panels had looked to Article III's broad objective of protecting the value of tariff concessions by ensuring strict trade neutrality and equality of competitive opportunity. In *Japan - Alcoholic beverages*, the Panel determined that "like product" should be given a broad reading for purposes of Article III in order to limit the scope for discriminatory taxes that distorted competition between similar goods.[25] The purpose of Article III would be subverted if contracting parties were allowed to promulgate artificial and contrived tax categories in order to target like imported products for higher taxes.

3.51 Despite variations in technology, features, styling, colour and price, all automobiles represented a single "like product" with a single, clearly defined end-use, common physical characteristics, and inter-related consumer demand. The CONTRACTING PARTIES had never developed a general, all-purpose definition of the term "like product", and GATT practice had been to interpret it on a case-by-case basis, taking into account, *inter alia*, "the product's end-uses in a given market; consumers' tastes and habits, which changed from country to country; and the product's properties, nature, and quality."[26] The higher the price of an automobile, the more likely that it would contain advanced technology and specialized features and would appeal to high-income consumers. Nevertheless, it was virtually impossible to identify distinct automobile products, or even distinct market segments. Instead, variations in automobile features,

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[25]BISD 34S/83, para. 4.6.

[26]Report of the Working Party on Border Tax Adjustment, BISD 18S/102.

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technology, and price took place on a broad continuum that ran from basic transportation on the one hand to cars embodying the most advanced technology, ride and comfort on the other.

3.52 Further the EC added that in applying the terms "directly competitive or substitutable", GATT panels had also looked to the purpose of Article III:2 and had taken a broad reading of "directly competitive" to ensure that taxes were not allowed to distort competition between related products. In *Japan - Alcoholic beverages*, the Panel had found that even if imported liquors were not considered 'like' to traditional Japanese liquors, "flexibility in the use of alcoholic beverages and their common characteristics offered an alternative choice for consumers leading to a competitive relationship ...".[27]

3.53 In addition, all cars offered basically substitutable choices, leading to direct competition based on price, size, design, safety, etc. Even if certain European cars tended to be more expensive than most American-built cars, there was a high degree of interchangeability and direct price competition, particularly with American vehicles priced for slightly less than $30,000. Thus, as the United States admitted, there is "substantial competition" between domestic and imported automobiles priced below and above the $30,000 threshold, rendering all passenger autos a single "like" product. Moreover, even if the Panel chose to treat autos priced at $30,000 and above as a distinct "like product", the US tax distorted competition by excluding certain (mostly domestic) cars, while hitting other directly competitive (mostly European) cars with a large penalty. This caused imported European models to sell at a significantly higher price and had the effect of affording protection to US "luxury" models in violation of Article III:2, second sentence.

3.54 While various features may affect the speed, comfort and safety of the ride, all automobiles had the same end-use: transporting passengers. Furthermore, all autos incorporated the same basic component parts, engine, chassis, tires, transmission, etc., which, although they may come in different sizes, designs, and types, served identical functions in all vehicles. If minor differences in automotive design, parts, or styling were found to generate different like products, this interpretation would lead to many like products, each entitled to separate tax treatment, would open a wide scope for protectionist abuse and would radically diminish the value of automotive tariff concessions.

3.55 The treatment of all passenger vehicles as a single "like product" was supported by the Harmonized Tariff System (HS), which contained a single tariff category No. 8703 which was subject to a single US tariff rate of 2.5 per cent, for "motor cars and other motor vehicles principally designed for the transport of persons ...". Because the HS was the standard international tariff nomenclature adopted by most contracting parties, it offered important guidance as to the treatment of passenger vehicles for purposes of Article III.[28]

3.56 Further, the "likeness" of all automobiles was further corroborated by past administrative rulings of the US Government. In *Certain Motor Vehicles and Certain Chassis and Bodies Therefor*,[29] the United States considered the definition of the appropriate "like product" for motor vehicles in the US market for purposes of GATT Article XIX. In that case, importers of European vehicles argued that their vehicles were unique and "did not compete with domestic products of any sort"; the US market should be divided into two distinct like products - large and small cars - and that this dividing line could be supported through consumer surveys and cross-elasticity studies. The US International Trade Commission (ITC) unanimously rejected both arguments, as follows:

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[27]BISD 34S/83, para. 5.7.

[28]Harmonized Tariff Schedule of the United States, USITC Pub. No. 2657 (1993).

[29]USITC Pub. No. 1110, Inv. No. TA-201-44 (Dec. 1980).

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> The reasoning which would lead to a subdivision of passenger autos into two or more industries is flawed in many respects. First, the very uncertainty about where to draw the dividing line illustrates vividly that what really exists is a full continuum of products. There is an endless choice of sizes and features. The same basic car body can be given a larger engine and a few optional features, thereby transforming it into a substantially larger car than a stripped down model. Most domestic producers offer a 'full line' of products, from subcompact to large and luxury cars, and all have a range of options that might change their classification. In reviewing the classification of 'small' versus 'large' autos suggested by one importer, it becomes obvious that one can find more similarity between the largest small car and the smallest large car than between products at either end of the small car spectrum.

3.57 Also, the EC noted that the Panel on *Spain - Tariff treatment of unroasted coffee* considered whether different varieties of coffee could be treated as separate like products for purposes of Article I. Spain sought to justify its separate tariff categories on the basis of varying geographical factors, cultivation methods, processing of the beans, and genetic factors. The Panel concluded, however, that such factors were insufficient to justify breaking coffee into separate tariff categories for purposes of applying different tariff rates. It emphasized that most coffee was sold in the form of blends and that in terms of end-use, coffee constituted a "well-defined and single product intended for drinking".[30]

3.58 Allowing contracting parties to apply different tax rates to different automobiles would invite protectionist efforts to target market segments dominated by imports. In enacting the luxury tax, the US Congress had failed to cite any credible reason why automobiles priced at $30,000 represented a distinct product category. If such tax categories were allowed to proliferate, the value of automobile tariff concessions would be seriously undermined.

3.59 The **United States** noted that GATT history and precedent established that it was not inconsistent with Article III to distinguish between similar products based upon objective criteria with a legitimate (non-protectionist) underlying policy purpose, as was the case here. As described further below, products were to be considered "like" if they met the regulatory criterion. In this case, cars were being classed according to price, and only cars priced above $30,000 were subject to the tax. They were not to be considered "like" (in the meaning of Article III) with products under the threshold. Cars above the threshold were treated alike, regardless of origin, as were cars below the threshold. The EC did not disagree that Article III permitted differentiation between products.

3.60 US analysis also showed that there was substantial US and Japanese competition for European cars in the price ranges just above the threshold; US vehicles continued to compete substantially into the $39,000 range. In other words, it was not the case that a separate category had been created to distinguish imports from domestic production. While there was a price range in which there was no domestic or Japanese competition - above $60,000 - it begged reason to argue that these vehicles were "like" or competed against domestic cars sold beneath the threshold, since American consumers tended to purchase cars within a price range of about 15 per cent. It could hardly be argued that a consumer wishing to buy a $60,000 automobile would switch to an automobile priced at less than $30,000 on account of a $3000 luxury tax.

3.61 The EC's argument that all automobiles were "like" for purposes of Article III was inconsistent with its argument with respect to the CAFE requirements and the gas guzzler tax where the EC argued that there was discrimination against a specific "segment" or "niche" of

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[30]Panel report adopted on 11 June 1981, BISD 28S/102, para. 4.6.

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European manufacturers. It was also evident that the EC's claim that European luxury vehicles were all "like products" to, or directly competitive with or substitutable for, domestic luxury vehicles was belied by the statements of its own manufacturers. In 1980, before the US International Trade Commission, BMW of North America argued that "Consumers did not consider the imported luxury automobiles and domestic automobiles - high priced or otherwise - as equivalent alternative purchases".[31] Mercedes similarly argued that its automobiles "are not like or directly competitive with domestic passenger cars" and that "in terms of quality and price, they occupied a unique, distinctive and separate position".[32] Both BMW and Mercedes favoured the utilization of a "value cutoff" to apply escape clause relief in an equitable manner (and exclude their automobiles.)

3.62 In *Certain Motor Vehicles and Certain Chassis and Bodies Therefor*, the Chairman noted:

> Some European importers even contend that their products are unique and do not compete with domestic products of any sort. The importers point to the great number of differences between "large" and "small" passenger vehicles. Most propose a classification based upon weight, size, engine specifications, wheelbase and other factors. They contend that it is logical to draw a line somewhere between "large" and "small" cars on this basis - that the auto industry itself draws several classifications based upon these criteria. Furthermore, they purport to demonstrate through consumer surveys and other cross-elasticity studies how demand for these two basic vehicle types differs, thus suggesting that they are not "directly competitive".[33]

3.63 The **European Community** argued that while GATT prohibited a contracting party from applying excessive taxes to imports, and that evidence of disproportionate impact was highly probative of discrimination, this did not necessarily mean that all like products had to be subject to exactly the same tax. In determining whether tax or regulatory distinctions between like products were legitimate, the Panel on *Japan - Alcoholic beverages* had looked to whether such distinctions (1) corresponded to objective product differences and (2) formed part of a broader trade-neutral system of taxation. That Panel "was unable to find that the differences as to the applicability and non-taxable thresholds of the *ad valorem* taxes were based on corresponding objective product differences (e.g. alcohol content) and formed part of a general system of internal taxation equally applied in a trade-neutral manner to all like or directly competitive liquors."[34] In special circumstances, a contracting party might also seek to justify a tax that did not meet this rule by invoking Article XX(g).

3.64 The above Panel had also considered evidence of the relative burdens imposed by ostensibly neutral tax and regulatory measures in assessing possible discrimination under Article III. In considering Japan's practice of dividing imported and domestic whiskies and brandies into three grades, the Panel stated, "As a result of this differential taxation of "like products", almost all whiskies/brandies imported from the EEC were subject to the higher rates of tax whereas more than half of whiskies/brandies produced in Japan benefited from considerably lower rates of tax." The Panel concluded, therefore, that … whiskies/brandies imported from the EEC were subject to Japanese taxes "in excess of those applied … to like domestic products" in

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[31]Prehearing Brief on Behalf of BMW of North America, Inc. (October 1980), *Certain Motor Vehicles and Certain Chassis and Bodies Therefor*, Inv. No. 201-TA-44, USITC Pub. 1110 (Dec. 1980).

[32]Post-Hearing Brief of Mercedes Benz of North America, Inc., *Certain Motor Vehicles and Certain Chassis and Bodies Therefor*, Inv. No. 201-TA-44, (Dec. 1980).

[33]Inv. No. 201-TA-44, USITC Pub. 1110 at 8-9 (Dec. 1980).

[34]BISD 34S/83, para. 5.9(b).

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the sense of Article III:2, first sentence.[35] Data of the US auto market made the same point as the above passage - almost all of the cars subject to the US luxury tax were imports (primarily from Europe) while almost all American cars escaped the tax.

3.65 The **United States** argued that the two-part test which the EC attributed to the *Japan - Alcoholic beverages* Panel Report was not in fact set forth there and was not derived from the text of the General Agreement. Although the Panel in that dispute had concluded that the Japanese tax categories for alcoholic beverages were inconsistent with Article III, in doing so it had found that the tax categories were based on subjective and intrinsically discriminatory criteria, led to much higher taxation levels in product categories designated as "Western" beverages than in categories that included "traditional" Japanese products, were unconnected to any general trade-neutral system of taxation, and were not based on legitimate (non-discriminatory) policy objectives. Article III was intended to permit taxes to differentiate among products. The EC admitted this despite the proscription against providing preferential treatment to "like domestic products". The EC argued that all automobiles were like products, but yet that Article III did not require that "all like products had to be subject to exactly the same tax". Accordingly, it proposed this two-part test to create an exception within Article III to tax different categories of "like products".

3.66 The proposed two-part test ignored altogether a very important factor in the analysis: the policy goals that were being pursued by the facially neutral measure. As such it did not accurately reflect the goals of Article III, which was to prevent measures being applied so as to protect domestic production. At the same time, to argue that every tax applied across the board and based on an objective physical characteristic would be consistent with the General Agreement, was going too far. Without a legitimate policy basis, a tax based on physical characteristics alone could be highly protectionist. For example, taxes based on engine displacement or cylinder size may serve no policy purpose at all except to restrict imports that may in fact have a much greater fuel economy than domestic products. Focusing on the objective of the tax, and whether the tax is reasonably designed to accomplish that objective, was a far more accurate way to assess whether a tax is protectionist than was the automatic approval proposed by the EC for any tax that applied to all products and differentiated based on an arbitrary physical characteristic. In the case of the luxury tax, the price criterion was an objective and reasonable measure of wealth for the purposes of implementing progressive taxation.

3.67 To reconcile the "like product" language of Article III with the accepted concept that Article III allowed taxes to differentiate among products, it made more sense to infer from the language and purpose of Article III that products meeting certain objective, trade-neutral criteria, as the measures at issue here, be considered "like products", while products not meeting those criteria not be considered "like" products that met the criteria. Categorizing among similar products based on irrelevant, immutable physical characteristics, rather than on objective criteria based on a legitimate policy, deprived imports of equivalent competitive opportunities and was strong evidence that the differentiation was intended to protect domestic production. On the other hand, where a tax or regulation was based on a legitimate policy, and simply provided equivalent competitive opportunities, a trade-neutral policy goal was presumed, and only the products meeting the established criteria were considered "like products". The criterion of the luxury tax was not intended to target imports specifically so as to afford protection to domestic production. Rather, the category created was objective and based on neutral fiscal and social policies. If it had an adverse trade effect on some foreign manufacturers, this was attributable to the manufacturers' business decisions, not to criteria that were intrinsically discriminatory.

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[35] *Id* at para. 5.9(a).

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3.68 The reasoning of the Panel on *United States - Alcoholic beverages* had specifically addressed the issue of product differentiation based on neutral criteria. It had examined, in the context of Article III:4, several US state measures on alcohol sales and found that:

> "The purpose of Article III is thus not to prevent … contracting parties from using their fiscal and regulatory powers for purposes other than to afford protection to domestic production … [nor] to prevent contracting parties from differentiating between different product categories for policy purposes unrelated to the protection of domestic production. The … limited purpose of Article III had to be taken into account in interpreting the term "like products" in this Article. Consequently in determining whether two products subject to different treatment are like products, it was necessary to consider whether such product differentiation is being made "so as to afford protection to domestic production".[36]

The Panel had found that the United States had not justified the creation of a category of wine produced from a variety of grape which could be grown only locally and in the Mediterranean region on any ground other than protection of domestic production and concluded that it was a "like product" to other still wines, and that the measures were inconsistent with Article III:2. In reaching this conclusion, the Panel had specifically noted that this category was "a rather exceptional basis for a tax distinction"[37], and that the United States had not justified its creation on any ground other than the protection of domestic production.

3.69 The United States explained that the Panel had applied the same approach but came to a different conclusion in deciding whether "low alcohol beer" and "high alcohol beer" should be considered like products. Even though the low-alcohol market was exclusively serviced by domestic manufacturers, the laws and regulations adversely affecting sales of high-alcohol beer "did not differentiate between imported and domestic beer as such …", and that therefore, "the burdens resulting from these regulations [did] not fall more heavily" on importers than on domestic producers.[38] The panel noted that the treatment of domestic and imported products as "like products" could have "significant implications for the scope of obligations under the General Agreement and for the regulatory autonomy of contracting parties with respect to their internal tax laws and regulations."[39] Once products were designated as like products, stated the Panel,

> … a regulatory product differentiation … becomes inconsistent with Article III even if the regulation is not "applied so as to afford protection to domestic production." … [I]t is [therefore] imperative that the like product determination in the context of Article III be made in such a way that it not unnecessarily infringe upon the regulatory authority and domestic policy options of contracting parties.[40]

After reviewing the social policies behind the beer laws and finding some market-based rationale for the distinction, the Panel had found that the measures were not applied to afford protection to domestic production, and that the products therefore were not "like products" under Article III, and were not inconsistent with Article III:4.

3.70 There were some common elements in the panel reports that considered *de jure* neutral measures to be inconsistent with GATT Article III. Categorizing on an "exceptional" basis on irrelevant or immutable characteristics of a product without any apparent legitimate policy purpose

[36]BISD 39S/206, para. 5.25.
[37]*Id* at para. 5.26.
[38]*Id* at para. 5.73.
[39]*Id* at para. 5.72.
[40]*Id* at para. 5.72.

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was considered to deprive imports of equivalent competitive opportunities. In the *Japan - Alcoholic beverages* case, the creation of a separate category based on the amount of a non-volatile ingredient, which was necessary to create the traditional formula for a liqueur, and the exclusion of a beverage from the lower tax rate of a spirit based on the very filtering method that gave it its identity (vodka) were not grounded in any legitimate policy. Accordingly, there was strong evidence that the differentiation was intrinsically intended to protect domestic production. On the other hand a different situation was presented where a tax or regulation was based on a legitimate policy, and simply provided equivalent competitive opportunities. In *United States - Alcoholic beverages*, the fact that domestic producers were exclusive suppliers of the market for low alcohol beer, which was taxed at lower rates, was irrelevant. In such a case, only the products meeting the established criteria were to be considered "like products" for purposes of Article III. This analysis was appropriate with respect to the luxury tax, which differentiated between vehicles on the basis of price, a reasonable measure of wealth for the purpose of a progressive tax.

3.71 A similar analysis was appropriate with respect to the second sentence of Article III:2, which extended to "directly competitive or substitutable products". If the tax regulated one product, but not another which was directly competitive or substitutable, and in which there was no substantial domestic production, a protective purpose may be inferred. On the other hand, if a single regulation affected a variety of directly competitive or substitutable products, the regulation should be considered consistent with Article III:2, second sentence and, as in this case, not designed to target imports as such to afford protection to domestic production.

3.72 In conclusion, the luxury tax was facially neutral and permissibly distinguished on the basis of an objective criterion that served a legitimate policy purpose. Accordingly, it was not directed to target imports as such, and was not applied so as to afford domestic production. Therefore, it was consistent with the General Agreement.

3.73 The **European Community** considered that under applicable precedent, GATT employed a two-step process to determine whether a challenged internal tax or other measure conformed with Article III. First GATT conducted an independent examination of the physical and commercial characteristics of imported and domestic merchandise to determine whether the two products were "like products". Second, GATT considered whether the challenged measure discriminated against the imported like product. The Panel on *Japan - Alcoholic beverages* described this GATT practice, and found that "past GATT practice has clearly established that like products in terms of Article III:2 are not confined to identical products but cover also other products, for instance if they serve substantially identical end-uses".[41]

3.74 The US reasoning would subvert this test. The US position was that the tax category or product classification chosen by a contracting party for an internal tax or regulation defined the "like product". In the Panel on *Japan - Alcoholic beverages*, Japan had taken a position that closely resembled this US position. Japan argued that "because each contracting party remained free to classify products for tax purposes, the 'likeness' or 'directly competitive or substitutable' relationship of imported and domestic products was legally not relevant to the interpretation of Article III:2 if … imported and domestic products were taxed in a non-discriminatory manner, regardless of their origin, within one and the same product category defined by a contracting party for tax purposes …".[42] The Panel had rejected this argument and pointed out that the term "like product" had been interpreted in Article I, which was the direct counterpart of Article III, "in the

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[41]BISD 34S/83, para. 55(b).

[42]*Id* at para. 5.4.

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sense not only of 'identical' or 'equal' products but covering also products with similar qualities".[43]

3.75 This broad interpretation of "like product" was necessary if Article III was to serve effectively against protectionism and discrimination. The above Panel had noted, "... only the literal interpretation of Article III:2 as prohibiting 'internal tax specialization' discriminating against like products could ensure that the reasonable expectation, protected under GATT Article XXIII, of competitive benefits accruing under tariff concessions would not be nullified or impaired by internal tax discrimination against like products ...".[44]

3.76 The fundamental objective of Article III was to ensure that functionally identical products were treated in a like manner for purposes of internal taxation, so that imports were provided equal competitive opportunities. If the Panel was to adopt the US theory of like product, it would be impossible to show that any internal excise tax was discriminatory. Since, by definition, all products within a tax category were taxed at a like rate, there could never be a tax on imports in excess of the tax on the like domestic product to violate Article III. If tax and tariff product categories could be drawn in narrow, specialized and artificial ways, it would become much easier to discriminate between countries in violation of the most-favoured-nation principle and between domestic and imported products in violation of Article III.

3.77 Further, the US view of "like product" was not supported by the holding of the Panel in *United States - Alcoholic beverages*. The "like product" discussion in the above Panel is *obiter dicta* - and not necessary or relevant to that Panel's ruling on the GATT-legality of restricting sales of high-alcohol content beer. Indeed, at the start of this Panel's deliberations, the Panel noted that "the burdens from the regulations do not fall more heavily on Canadian than US producers."[45] The Panel did not need to go any further in order to determine that the challenged restrictions were non-discriminatory. But, even as dicta, the above Panel's description of Article III practice was, in the EC's view, incorrect and inconsistent with established GATT practice, as set forth in *Japan - Alcoholic beverages*.

3.78 The US concern, that a broad definition of "like product" could foreclose governments' autonomy to distinguish between products for purposes of achieving legitimate environmental, tax, and standards objectives, was misplaced. The *Japan- Alcoholic beverages* Panel directly addressed this concern by emphasising that a finding of "like product" did not foreclose differences in taxation, as long as such differentiation (1) arose from objective product differences, and (2) reflected the application of a trade-neutral system of taxation applied equally to all like or directly competitive imported and domestic products.[46]

3.79 The EC did not consider that a contracting party was in a tax or regulatory prison with respect to a like product. Even if all whisky was a single like product, Japan could still have justified its system if it could have shown that the tax differential corresponded to some objective product difference, such as a much higher alcohol content of special grade whisky, and was part of a general policy of taxing all alcoholic beverages according to their alcohol content. This case showed that a like product finding did not preclude application of different taxes and regulatory classifications to goods falling within the product category. Thus, if a contracting party maintained a policy of taxing individual automobiles by engine displacement, it could apply higher taxes to larger automobiles, consistent with GATT. Similarly, a general policy of taxing cars by

[43]*Id* at para. 5.5(a).
[44]*Id* at para. 5.5(b).
[45]BISD 39S/206, para. 5.73.
[46]BISD 34S/83, para. 5.9(b),

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their levels of hydrocarbon emissions or fuel consumption would also be legitimate. The key, however, should be whether the tax was general enough to cover substantial domestic production.[47] This would ensure domestic political cost, and avoid the existing situation in which the US policies of discouraging excessive consumption by the rich was expressed almost exclusively by taxing European cars.

3.80 The **United States** noted that the General Agreement did not preclude progressive taxation simply because several European manufacturers exported very expensive cars. The issue for the Panel was not the overall proportion of European vehicles taxed or the revenues received. This was not a situation where, for example, no tax was applied to a domestically produced product on the one hand, and a very high protective tax is applied to a directly competitive import, on the other. The luxury tax did not involve a drastic transition so as to effectively create two categories for competitive vehicles, subjecting a vehicle to radically different tax treatment once it crossed the threshold. Indeed, since the tax was only applied on the portion of the price above $30,000, little tax was paid by vehicles just above this threshold as compared to vehicles just below the threshold; $100 for a vehicle priced at $31,000.

3.81 Moreover, the US analysis showed that the threshold did not protect domestic production; there was substantial competition between imports and domestic products above and below the threshold. Examining sales between $25,000 and $30,000 showed that imports were heavily represented in the price range just below the threshold. Clearly the tax was not designed to protect domestic production from imports if a substantial number of imports narrowly escaped the tax, and competed directly with US products at those prices. (Above the threshold, imports and domestic products were taxed alike.) The EC had not shown in any way that the threshold itself was designed to protect domestic production.

(c) Threshold and coverage

3.82 The **European Community** noted that in *Japan - Alcoholic beverages*, Japan had argued that GATT gave a contracting party freedom to classify products for tax purposes. The Panel rejected Japan's contention that the only obligation of Article III was to apply a non-discriminatory rate, regardless of origin, within each separate product category defined by a contracting party for tax purposes. Thus, under Article III a contracting party could not define tax categories in ways that established artificial and irrational distinctions between "like" domestic and imported products, so that imports were singled out for higher levels of taxation.

3.83 In the above Panel, Japan had defended its higher taxes on categories and sub-categories of imported distilled spirits, whiskies, and brandies on the grounds that Japanese policy was to impose "higher tax rates on high-quality, high-priced products so that consumers bear a tax burden commensurate with their purchasing power".[48] Japan had also contended that it had a right under GATT to seek to promote consumption of "traditional" liquors, such as sake and shochu. The Panel rejected this line of argument.[49] Allowing tax specialization based on price differences

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[47]The EC added that at the Havana Conference, the drafters clarified that:

> Under the provisions of Article 18 regulations and taxes would be permitted which, while perhaps having the effect of assisting the production of a particular domestic product (say, butter) are directed as much against the domestic production of another product (say domestic oleomargarine) of which there was a substantial domestic production as they are against imports (say, imported oleomargarine).

(Reports of the Committees and Principal Sub-Committees, ICITO 1/8, 64 (Geneva, Sept. 1948)).

[48]BISD 34S/83, para. 3.9(a).

[49]*Id* at para. 5.13.

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would have had the effect of disadvantaging imported products, which generally sold for a price premium, and did not appeal to exactly the same class of consumers. It would also permit creative tax officials to introduce multiple tax rates that would have the effect of shifting tax burdens to market segments dominated by imports. In the United States, many imported products had to sell at a discount from the prices of American manufacturers for several reasons such as perceived advantages in dealing with a US manufacturer and shorter delivery times. Other products, including European automobiles, sold in the United States at a substantial price premium, because of superior engineering, quality, styling, etc.

3.84 The **United States** considered that the EC's assertion, that a tax based on the price of a product should not be considered a legitimate basis for a distinction for tax purposes, relied largely on the Panel on *Japan - Alcoholic beverages*. However, this Panel had not found that a price threshold could not be the basis for the imposition of an *ad valorem* tax, rather, it had focused on Japan's creation of distinct tax categories and grades based on subjective factors such as perceptions of a certain beverage as a high quality or low class item.[50] The Panel properly concluded that such subjective concerns were not an appropriate basis for distinctions between like products under the General Agreement, since they could serve to "crystallize consumer preferences[51]... and did not form part of general system of internal taxation equally applied in a trade neutral manner".[52]

3.85 The US luxury tax on automobiles was not comparable to the subjective assessments, such as whether a product was perceived as "high quality" or appealing to the lower classes, which were made by Japanese authorities determining a beverage's classification into a low-tax or highly taxed category. Nor was it comparable to the kinds of contortions made by such authorities in defining the "grades" of alcoholic beverages. The US luxury tax on automobiles was based on a single objective criterion applied across the board to imports and domestic products alike. The General Agreement did not infringe on the right of a government to exempt a portion of the value of a product from taxation, as the luxury tax did, as long as that exemption applied to imports and domestic products alike. The drafting history and the purpose of Article III made clear that GATT contracting parties retained the right to promulgate taxes or regulations that created distinct categories among similar products, but that did not, on their face, discriminate against imports. The United States understood that Australia and Denmark also had automobile taxes with price thresholds.

3.86 Moreover, as a factual matter, the EC's assumption that the tax was intrinsically unfair to imports because European products sold at a substantial price premium, could not be universally applied to all European imports. To assume that all European imports were marked up by dealers implied that such a premium would not also be applied with respect to domestic and Japanese products. Moreover, imported automobiles generally did not sell "at a premium price" any longer, given the world recession and fierce competition for selling automobiles. This occurred only if a particular model was extremely popular, a characteristic just as likely to be applicable to domestic as imported automobiles. As noted elsewhere in the EC's submission, the manufacturer's retail sales price was the starting point of a negotiation between a potential customer and the automobile salesman, and the final price to the consumer was more likely to decrease rather than "sell at a premium".

3.87 The **European Community** argued that the $30,000 threshold was entirely artificial and it did not correspond to objective product differences, since there were no clear-cut distinctions

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[50]*Id* at para. 3.10(a).

[51]*Id* at para. 5.7.

[52]*Id* at para. 5.9(b).

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between cars priced above and below the threshold, except price and (in most cases) origin. While the term "luxury car" was used frequently in US automotive advertising by both domestic and foreign manufacturers, it had no established meaning. Use of this artificial $30,000 threshold allowed imposition of the tax on imported vehicles while "like" or directly competitive domestic products escaped taxation altogether or paid only minimal amounts. While other cars were commonly classified according to size (e.g. compact, mid-size), the luxury car market reflected a combination of factors, including price, consumer perceptions, brand name, styling and technology. Various industry sources differed in their definition of "luxury". Ward's Automotive Yearbook included eighteen American vehicles in the "luxury" market segment, of which thirteen (72 per cent) had MSRPs below $30,000.[53]

3.88 Advertising campaigns by the Big Three underscored the fact that many cars selling for less than $30,000 were competing in the "luxury" car market, yet those above the threshold were subject to tax, while those below the threshold escaped tax entirely. Indeed, most American-built "luxury" vehicles sold for less than $30,000. Chrysler advertised the New Yorker (MSRP $29,046) as a "six passenger luxury car". General Motors (GM) advertised the "quality, safety, and luxury of the stylish Park Avenue" (MSRP $26,040) under its "luxury lease program". It quoted publications naming the Park Avenue as the "best American luxury car value". GM materials for the Buick Roadmaster Sedan (MSRP $22,505) indicated that "safety was not the only impressive feature on this luxury automobile". Even the Oldsmobile Cutlass Supreme (MSRP $16,995) was advertised as a "luxury car".

3.89 Focusing on consumer preferences, it was clear that cars priced above and below the threshold competed directly. Following enactment of the luxury tax, there was a precipitous drop in sales of European automobiles, as American consumers shifted to less expensive cars to avoid the tax. Thus Rolls Royce's annual sales dropped 53 per cent immediately following enactment of the tax. In addition, European manufacturers had also experienced a dramatic shift in product mix, as consumers had shifted to less expensive models. BMW, for example, had experienced a sharp drop in sales of the 7 Series cars, which, according to the Luckey study, had estimated retail transaction prices in the $49,000 to $74,000 range and were subject to a luxury tax of $1,800 to $4,200, while sales of the 3 Series cars (estimated retail transaction prices of $21,000 to $33,000) had increased. Mercedes-Benz had experienced a similar shift from its top-of-the line S Class, which was subject to a luxury tax of $1,834 to $8,907 per vehicle (estimated retail transactions prices of $50,000 to $119,000) to its less-priced E and C Class vehicles.

3.90 The United States did not have a general, trade-neutral system for taxing luxury goods. Instead, it singled out five products for a highly punitive 10 per cent luxury tax imposed on an *ad valorem* basis above chosen thresholds. Of these five taxes, four - furs, boats, private planes, and jewelry - were no longer subject to the tax under the 1993 Budget Reconciliation Act, due to intense lobbying efforts from domestic manufacturers who were able to cite extensive job losses as a result of the tax. European automobile manufacturers were unable to make this argument because their effects were felt abroad. The absence of any legitimate connection to a general trade-neutral system of luxury taxation was corroborated by the lack of an objective basis in tax policy for the $30,000 threshold for automobiles. When the automobile luxury tax was originally discussed in the US Congress, much debate focused on establishing the price threshold, initially proposed at $20,000 to maximize revenue. It was subsequently raised to $25,000 and then to

[53]1991 Ward's Automotive Yearbook, p. 209. United States-produced cars designated as luxury vehicles by Ward's Yearbook and the MSRP: Buick Electra ($20,775), the Chrysler Fifth Avenue ($21,410), Oldsmobile Toronado ($22,545), Buick Riviera ($23,590), Chrysler Imperial ($26,045), Oldsmobile 98 ($27,345), Cadillac De Ville ($27,510), Cadillac Brougham ($27,950), Lincoln Town Car ($28,541), Buick Regatta ($28,885), Cadillac Eldorado ($29,045), Lincoln Mark ($29,801), and the Lincoln Continental ($29,997).

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$30,000 in order to shield domestic producers. In fact, even in 1993, after several years of increased costs and new models, this threshold still excluded approximately 98 per cent of all domestically produced vehicles.

3.91 The EC added that the arbitrary nature of the $30,000 threshold was further demonstrated when Congress increased the "luxury" price threshold to $32,000 and indexed the tax for inflation. This would exempt domestic vehicles whose transaction prices were increasing and underlined the protectionist nature of the tax. Repeated manipulation of the threshold demonstrated the lack of connection between the tax and any GATT-consistent public policy purpose. Instead, the United States had selectively taxed a very small segment of the automobile market composed primarily of imports. Such selective taxation was inconsistent with the letter and spirit of Article III.

3.92 Use of an arbitrary price threshold to penalize imports had been condemned previously. In *Japan - Alcoholic beverages*, Japan had sought to justify different *ad valorem* levels of taxation as part of a general policy of "taxation according to tax-bearing ability", i.e. progressive taxation of the rich, much as the United States was claiming for the luxury tax. Noting that tax thresholds did not violate Article III *per se*, the Panel nevertheless had concluded that the Japanese thresholds violated Article III:2 because they *de facto* discriminated against imports and were arbitrary.[54] The taxes did not correspond to a rational overall system for taxing all liquors, such as one based on alcohol content. Even though the system was facially neutral and applied to imported and domestic liquors, the thresholds had the effect of isolating certain imported liquors for a sharply higher incidence of taxation compared to like Japanese liquors. This was the same as for the luxury tax. The United States did not have a general excise tax on all automobiles, but only one automobile excise tax on a narrow category of automobiles priced at $30,000 and above. It was designed to accomplish two objectives: (1) raise revenues to close the federal budget deficit, and (2) minimize any burden on domestic automobile producers. This contrasted with other legitimate public policy goals that might justify differential treatment of like vehicles for tax purposes. While the tax purported to penalize upper-income purchasers of expensive autos, the *Japan - Alcoholic beverages* Panel established that seeking to manipulate consumer preferences to the disadvantage of imports was not a legitimate policy rationale that justified discrimination under Article III:2.[55]

3.93 The **United States** disputed that the tax had been responsible for any alleged market decline in European exports. The important factor noted by the Panel in the *Japan - Alcoholic beverages* report was that ill-defined and arbitrary criteria determined whether a product was in one category or another for purposes of a tax; the Panel had *not* concluded that price thresholds were inconsistent with the General Agreement. Unlike the taxes at issue in that dispute, the structure of the US luxury tax was based on serious legitimate policy concerns. While the threshold could have been set slightly higher or lower than $30,000, it served the purpose of the tax, because $30,000 was well above the average and median prices for an automobile in the United States, which in 1991 was around $16,500. In 1991, cars selling for $30,000 and above made up less than 5 per cent of the US automobile market. The EC's assertion that a price threshold was not an objective criterion was absurd, given that price was generally the basis for assessment of both tariffs and excise taxes, and was the surest measure of ability to pay. The application of a threshold was a necessary part of policy making. In the United States, an automobile was generally a necessity, not a luxury, but in the higher price ranges, the necessity became a luxury. The fact that this transition did not occur at a finite point did not mean that the General Agreement prevented a party from taxing progressively.

[54]BISD 34S/83, para. 5.9(b).
[55]*Id* at paras. 5.9(b), and 5.13.

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3.94 The luxury tax was imposed when the US Congress needed to find additional revenues to address a burgeoning budget deficit. At the same time, it was also concerned that any taxes raised should not be perceived to burden the middle and lower income brackets; it attempted to tax higher income Americans who had benefitted from substantial tax cuts in 1981. Congress was also concerned about the low level of national savings. A luxury tax was seen as a means to raise revenue while addressing these concerns.

3.95 In the summer of 1987, the Congressional Research Service of the US Library of Congress (CRS) prepared a report for Congress reviewing past luxury taxes and analysing their economic consequences. CRS reported that there were no sizable consumption expenditures that were progressively distributed across all income classes, and stated: "Exempting lower priced items, or a given dollar amount of each purchase, from taxation could create a progressive distribution of taxation for many expenditures". CRS acknowledged that such an approach would reduce the size of the tax base, but that "there are virtually no data on purchases by amount spent per item, so measuring such a tax base would be virtually impossible".[56]

3.96 The luxury taxes eventually adopted attempted to strike a compromise between raising revenue and ensuring that the tax did not burden lower and middle income groups. In 1987, the Joint Committee on Taxation recommended, among over a hundred possible sources of revenue, taxes on automobiles priced over $20,000, on boats priced over $15,000, on jewelry priced over $100, and on aircraft, furs and consumer electronics without a threshold. The concern was to strike a balance on the side of revenue raising. Further along, the thresholds were raised for the first three items and imposed on aircraft and furs. Ultimately the tax base was narrowed to make the luxury taxes more progressive: automobiles priced over $30,000, boats over $100,000, aircraft over $250,000, jewelry over $10,000 and furs over $10,000.

3.97 In the budget process, the automobile threshold was raised from the recommended $20,000 to $30,000. However, the EC's inference, that this was to afford protection to domestic production, was unreasonable for several reasons. First, the thresholds for other items were also raised during the process. The most dramatic increase for boats went from $10,000 to $100,000, and was with respect to an industry largely immune to import competition. Second, had the threshold been set at $20,000, an estimated 71.6 per cent of all European exports would have been subject to the tax (according to the EC's estimates), instead of the EC's estimated 38.5 per cent subject at the $30,000 threshold. Given that with a threshold of $20,000, only 9.7 per cent of US production would have been subject to the tax, the EC's "disproportionate impact" case would have been even stronger. Had the threshold been higher, European automobiles would have been almost the exclusive source of revenue. Indeed, any tax on the value of a vehicle was likely to disproportionately impact exports of particular EC manufacturers, since their automobiles were on average more expensive than American or Japanese vehicles. The fact that some manufacturers in the territory of one contracting party exported high-priced products for consumers in high-income brackets should not prevent another contracting party from imposing a progressive tax on the basis of the price applicable to that type of product generally. Finally, the tax was not even levelled at imports as such, since less than 9 per cent of all imports were covered by the tax. As stated by the Panel in *Japan - Alcoholic beverages*, "Article III:2 does not prescribe the use of any specific method or system of taxation".[57]

3.98 The **European Community** considered that the fact that some imports escaped the luxury tax was irrelevant for GATT purposes. As the report of the Panel on *United States - Section 337*

[56]Congressional Research Service, The Library of Congress, *History and Economics of US: Excise Taxation of Luxury Goods*, CRS, 17 June 1987, pg. 4.

[57]BISD 34S/83, para. 5.9(c).

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of the Tariff Act of 1930 noted, a contracting party could not defend a discriminatory measure by claiming that it had an adverse effect on some, but not all, imports. The Panel had found "that the "no less favourable" treatment requirement of Article III:4 has to be understood as applicable to each individual case of imported products".[58] The US reasoning would give a contracting party free licence to discriminate against sub-classes of imports, as long as it did not discriminate against the entire class of all imports. Such a rule would have adverse consequences for the manufacturer, or contracting party, whose goods were targeted and for whom GATT benefits under Article III would be non-existent. The rule adopted by the above Panel was more consistent with GATT's objective of promoting increased trade than that proposed by the United States.

3.99 During the discussions of the threshold, all US industries potentially subject to luxury taxes sought to eliminate the tax or raise the threshold as high as possible to limit its damaging effects on business. The sharp increase in the boat threshold was consistent with the EC's case regarding luxury cars, since it reduced the impact of the boat tax on American production. The luxury tax on automobiles was increased until it essentially did not affect American-built cars and was left so that it applied almost exclusively to European imports.

3.100 Furthermore, the US argument, that a tax set at $20,000 and above would have affected even more European cars but only 9.7 per cent of American cars, showed that the national treatment obligation reflected political reality. In 1990, this threshold would have covered an additional 580,564 American cars, leading to strong objections from the Big Three and American auto workers and consumers. The United States would have been required to bear the political costs of taxing substantial domestic production, as contemplated by Article III.

3.101 The **United States** considered the EC's legal analysis faulty in relying on past disputes involving *de jure* discrimination. Of course where a country expressly discriminated against only one contracting party, there was a clear violation of Article III. But where, as here, a contracting party established measures based on neutral criteria, protectionist intent could not be inferred from the alleged effect on a few importers. The low number of imports affected made a strong case that the *de jure* neutral measure was not being applied "so as to afford protection to domestic production."

(d) Nullification and impairment under Article XXIII:2

3.102 The **European Community** noted that under longstanding GATT law, a violation of the General Agreement normally established *prima facie* presumption of adverse trade effects for purposes of showing nullification and impairment under Article XXIII:2. In cases involving violations of Article III, however, it had been held that GATT-illegal discrimination constituted *per se* nullification and impairment. In the Panel on *United States - Taxes on petroleum and certain imported substances*, the United States had conceded that it was imposing a discriminatory tax on imported petroleum-based products, but had argued that the tax was small and the trade effects were insignificant. The Panel rejected the alleged lack of trade effects as a defense to Article III discrimination: "A demonstration that a measure inconsistent with Article III:2, first sentence, has no or insignificant effects would therefore 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."[59] If the Panel were to find that the luxury tax violated Article III:2, first sentence, it would represent *per se* nullification and impairment under Article XXIII.

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[58]BISD 36S/345, para. 5.14.

[59]BISD 34S/136, para. 5.1.9.

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3.103 The Panel in *Japan - Alcoholic beverages* extended this rule to Article III:2, second sentence, finding that discrimination involving directly competitive products also did not require a showing of trade effects.[60] Thus, if the difference in the taxation of directly competitive products was "considerable", a discriminatory tax was presumed to afford protection to the domestic industry under Article III:2, second sentence. In fact, many US dealers actively advertised that their products were not subject to the luxury tax.

3.104 In this case, a heavy 10 per cent *ad valorem* levy against imported European cars was more than "considerable". It represented a deliberate and successful US policy to discourage consumption of certain expensive (mostly European) automobiles.[61] The adverse impact of the tax had been further exacerbated by the extreme price-sensitivity of the "luxury" car market. A "luxury" automobile represented a discretionary purchase for most consumers, since less expensive alternatives were available to perform the same end-use. In fact, US consumers had responded by shifting to less expensive domestic and imported vehicles.

3.105 While proof of trade damage was not required under Article III:2, in fact the imposition of the luxury tax had coincided with a steep decline in US sales of European automobiles. The Luckey study estimated that in 1990, 147,253 European automobiles were sold in the United States at prices of $30,000 or higher. In November and December 1990, when consumers learned that they would be liable for the luxury tax on 1 January 1991, sales of European autos shot up to 15,567 units, or 35 per cent more than would have been expected without the tax.[62] Thereafter, sales declined catastrophically to approximately 109,000 units in 1991 and 1992. In addition, the luxury tax had resulted in a shift in product mix for European auto manufacturers and for American consumers who shifted to less expensive vehicles or deferred the purchase of a new automobile. Thus, sales of the largest and most expensive imported European autos had suffered the sharpest declines, somewhat offset by increased sales of less expensive luxury cars. There was no doubt that the luxury tax distorted trade flows and caused serious harm to the interests of European auto producers. The luxury tax therefore violated Article III:2, second sentence, and nullified or impaired benefits accruing under the General Agreement.

B. Gas Guzzler Tax

(i) Article III:2

(a) Charges or taxes in excess of those applied to domestic products

3.106 The **European Community** argued that although the gas guzzler tax originally had been intended to discourage the purchase of all automobiles that consumed excessive amounts of fuel, in fact it had had a discriminatory impact since its inception. All automobiles represented a single "like product" for purposes of Article III. The arbitrary threshold of 22.5 mpg taxed a small segment of US auto sales, targeted imported European autos almost exclusively, and burdened European producers with a disproportionate share of the tax. Article III:2, first sentence, prohibited a contracting party from applying to imports internal taxes 'in excess of those applied, directly or indirectly to like domestic products'. The US EPA applied the gas guzzler tax in such a way as to single out European automobiles for a discriminatory tax and exempt US-built autos with the same or worse fuel economy. Article III:2, second sentence, prohibited a contracting party from applying an internal tax "so as to afford protection to domestic production", contrary

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[60]BISD 34S/83, para. 5.11.

[61]The EC recalled that the gas guzzler tax was considered part of a vehicle's sales price for purposes of the $30,000 luxury tax price threshold.

[62]Temple, Barker & Sloane, Inc., "Economic Effects of the Automobile Luxury Tax", (May 1991) pg 5.

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to the principles of Article III:1. Since Article III:2 referred to the application of taxes, it was the effect of a tax when applied rather than its status when adopted that was determinative. While Article III:2, second sentence, did not require proof of protectionist intent, evidence that the US Congress had targeted the gas guzzler tax at European automobiles with the aim of discriminating against imports was plainly relevant. Indeed, the disproportionate impact of the tax was recognized by the US Congress, as evidenced by the statement of Senator D'Amato when he first proposed to double the gas guzzler tax in 1988: 'According to the EPA, in model year 1988 only the most expensive imported cars triggered this tax. There are absolutely no domestic-made cars that are impacted by this tax'.[63] This impact had been exacerbated when the tax was doubled in 1990.

3.107 The **United States** noted that the gas guzzler tax was a facially neutral measure which applied equally to imports and domestic products, and rejected the EC's suggestion that a "disproportionate impact" on one per cent of imports made a measure inconsistent with Article III:2. The drafting history, and the purpose of Article III, made clear that GATT contracting parties retained the right to promulgate trade-neutral taxes or regulations that created distinct categories among similar products, or encouraged the manufacture of goods according to particular specifications. The gas guzzler tax's trade-neutral distinction among vehicles based on their fuel efficiency was precisely the kind of measure unaffected by the national treatment provisions of the General Agreement.

3.108 At the Havana Conference it was specifically clarified that Article III:2 did not prevent contracting parties from differentiating among product categories on a basis other than national origin, such as in the use of internal regulations required to enforce standards.[64] As noted with respect to the luxury tax, the Panel in *United States - Alcoholic beverages* had found that "the purpose of Article III is not to prevent contracting parties from differentiating between different product categories for policy purposes unrelated to the protection of domestic production."[65] The Panel also explicitly recognized the need to permit "a regulatory product differentiation, e.g. for standardization or environmental purposes".[66]

3.109 When the tax was first implemented, it appeared that imports were in the best competitive position to deal with the tax since, proportionately, American automobiles were the least fuel-efficient. In 1978, the Big Three had 75 per cent of the automobile model types under 22.5 mpg (315 out of 418). Moreover, when the tax was increased, it was extended to cover limousines, a category of vehicle that was almost exclusively manufactured by domestic producers. Any "disparate" impact in recent years on certain European exports arose from the US manufacturers' significant improvements in the fuel efficiency of their large automobiles in contrast to the recalcitrance of some European manufacturers. Although European imports accounted for only 4 per cent of the US market, they now accounted for about 83 per cent of the sales of cars with fuel economies below 22.5 mpg. In other words, any "disproportionate impact" of the tax in recent years on European manufacturers stemmed from their disproportionate share of gas guzzling automobiles.

3.110 The **European Community** argued that according to the Luckey study, when Congress doubled the gas guzzler tax in 1990, forty-five of the forty-seven models subject to the tax were imported and forty-four of those forty-five were European (the other was Japanese). Only two domestic vehicles - the Cadillac Fleetwood Brougham and the Cadillac Allante - were vulnerable

[63]Congressional Record S450 (February 2, 1988) (Statement of Senator D'Amato).

[64]Reports of Committees and Principal Sub-Committees: ICITO 1/8, Geneva, September 1948, p. 64, para. 54.

[65]BISD 39S/206, para. 5.25.

[66]*Id* at para. 5.72.

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to the gas guzzler tax.[67] Thus, of 6,563,527 passenger automobiles made and sold in the United States in 1990, 34,244 or 0.5 per cent were subject to the increased gas guzzler taxes. In contrast, of the 395,958 European cars sold in the United States in 1990, 71,449 or 18 per cent were subject to the gas guzzler tax.

3.111 As a result, European manufacturers accounted for most of the gas guzzler tax revenues. In 1990, 73.36 per cent of the total taxes paid were derived from European manufacturers, although European cars accounted for only 4 per cent of the US market. In contrast, US production accounted for only 19.91 per cent of total tax paid, although it accounted for 72 per cent of the US market. By 1992, the share of gas guzzler taxes paid by US manufacturers had fallen sharply to 2.76 per cent, and only 2,070 US-built cars were still subject to the tax, as opposed to 34,204 in 1990. Although the number of European cars subject to the tax fell from 71,449 in 1990 to 42,326 in 1992, in part because the doubled gas guzzler tax coupled with the luxury tax led to a sharp decline in sales of large, expensive cars, the European share of gas guzzler taxes paid rose to 84.97 per cent.

3.112 The **United States** reiterated that there was no basis or support for the "disproportionate impact" theory proposed by the EC. Measures that were *de jure* neutral should generally be presumed to be consistent with the General Agreement. As noted with respect to the luxury tax, the Panels in the *Japan -, United States -,* and *Canada - Alcoholic beverages* disputes had considered *de jure* neutral measures inconsistent with Article III only when they appeared intrinsically protectionist - when it was clear that the regulatory distinctions at issue were "rather exceptional" and not based on legitimate policy criteria. This made it likely that the measure was being applied so as to afford protection to domestic production, inconsistent with the purpose of Article III. The gas guzzler tax had never targeted imports as such for the purpose of affording protection to domestic production. Its purpose was to complement CAFE requirements by forcing all manufacturers to comply with fuel-efficiency standards on even their least efficient automobiles. It was facially neutral, was applied on the basis of neutral criteria, and did not impair equal competitive opportunities available to imports and domestic cars. Like standards, it differentiated permissibly among products, though, unlike standards, it did not go so far as to prohibit entry into the market.

3.113 Moreover, the tax did not even affect the vast majority of vehicles imported into the United States. For example, for the 1993 model year, based on the projected sales estimates used in calculating the gas guzzler model type fuel economy values, only 1 per cent of imports were affected. For the same year, almost 90 per cent of the European manufacturers' vehicles projected to be imported into the United States (including those imported by Volkswagen, Volvo and Saab) were not subject to gas guzzler tax because they exceeded the fuel economy threshold of 22.5 mpg. Historically, all (with few exceptions) vehicles imported by Asian manufacturers had similarly exceeded the applicable gas guzzler thresholds and therefore not been subject to tax (for 1993, only the Q45 imported by Nissan failed to exceed the gas guzzler fuel economy threshold of 22.5 mpg).

3.114 From the outset, the gas guzzler tax reflected a long-term energy conservation policy to discourage the production of very fuel-inefficient automobiles. The amount of the tax increased as the fuel-efficiency of a vehicle decreased under 22.5 mpg, providing tangible incentive to increase fuel efficiency even by increments. It applied to all automobiles that attained less than a specified gas mileage, and therefore created incentives for buyers to purchase vehicles that exceeded that level, regardless of whether they had been produced domestically or imported.

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[67]The European Community noted that the United States subsequently had stated that the Allante, which was manufactured in Italy, was in fact, an import.

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3.115 As argued with respect to the luxury tax, Article III:2, first sentence, required that imports be provided equivalent opportunities, not guaranteed trade flows. Regulations that created special procedures or methods of assessment that were applied only to imports were presumed to be inconsistent with Article III:2, first sentence; however, the fact that a facially trade-neutral tax or regulation might have a "disproportionate impact" on the products of a particular contracting party did not meet the burden required by Article III to show that different conditions of competition were being established for imports and domestic production.

3.116 The EC was challenging the gas guzzler tax largely on the basis of the incidence of the tax. However, this so-called "disproportionate" impact was a function of what European producers chose to market in the United States, as opposed to what they produced, since European manufacturers produced a broad range of fuel-efficient automobiles and were no doubt capable of exporting them to the United States. The General Agreement did not prevent a contracting party from pursuing a fuel economy or other policy objective simply because manufacturers from another contracting party decided to save themselves the expense of conforming with that policy. Over the years that the gas guzzler tax had been in force, certain European manufacturers had sent to the United States less efficient automobiles with progressively lower average fuel-economy values. However, their options for improving the fuel economy of their import offerings to avoid the tax were no different than the options available to other manufacturers. Between 1980 and 1990, the BMW 7-series model fuel economy grew by less than ten per cent and comparable models by Mercedes actually had a six per cent decline in fuel economy. Due to their emphasis on fuel-efficient design, the fuel economy of comparable US luxury models grew between 25 and over 31 per cent during the same years. The failure of certain European manufacturers to improve the fuel efficiency of their vehicles when faced with gas guzzler fuel economy thresholds established by law many years earlier did not indicate that the tax was intended to protect domestic production. Rather, European manufacturers accounted for most gas guzzler tax revenue because domestic companies had paid large amounts of money to improve the fuel economy of their vehicles, while some European companies had not chosen to do so.

3.117 In 1993, only 1 per cent of imported passenger automobiles were subject to the gas guzzler tax (compared to 0.1 per cent of domestic production),[68] and automobiles sold by US manufacturers made up 12 per cent of those subject to tax. Mercedes-Benz vehicles contributed 50 per cent, BMW 22 per cent, Japanese manufacturers 5 per cent and other European manufacturers 11 per cent. Thus it could hardly be claimed the tax was applied to protect domestic production by targeting imports as a whole.

3.118 The **European Community** argued that the US reasoning would allow a GATT contracting party to maintain indefinitely measures that, though they might have begun as GATT compatible, had evolved into protectionist, GATT-illegal barriers to trade. Article III:2 referred to the application of taxes. Thus, it was the effect of a tax when applied, rather than its status when adopted that was determinative. The statistics presented above showed that this tax had applied almost exclusively to imported European automobiles. The United States was simply seeking to reduce its massive budget deficit by singling out European vehicles for discriminatory tax treatment in violation of Article III:2, first sentence.

3.119 Two assertions by the United States were incorrect: first, that European manufacturers did not meet the gas guzzler tax threshold because of conscious business decisions not to do so; and second, that European firms had obtained a competitive advantage over domestic manufacturers by refusing to invest in fuel-efficient technology. The arguments against these assertions were explained in the CAFE section; however, several points were important to the gas

[68]EPA database of confidential sales information.

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guzzler tax. First, European manufacturers historically had relied on the use of fuel-efficient diesel engines to attain high fuel economy for their larger vehicles and to meet the requirements of the US law. As a result of economic and regulatory forces beyond the control of European manufacturers (a change in the cost of diesel and a change in treatment of the emissions of diesel engines) diesel engines became no longer viable in the early to mid-eighties. Second, European manufacturers had invested substantial sums in improving the fuel efficiency of their vehicles. The comparatively low fuel economy was a function of the weight and performance characteristics of "luxury" class vehicles, not the inefficiency of the engine. Third, the downturn in the early to mid-eighties in the fuel economy of European cars was caused by smaller, EC producers being driven out of the US market by competitive forces, therefore changing the product mix of the European imports. Market forces and demand drove the European imports to the top end of the market where the US manufacturers had been less represented; EC manufacturers did not arbitrarily decide to offer such cars; there were market constraints on what they could sell in the US market.

3.120 Further, the United States had not challenged the EC statistics on relative gas guzzler tax burdens for 1991 and 1992. With respect to 1993, the United States claimed that 12 per cent of the cars subject to the tax were sold by US manufacturers, providing a misleading impression. The cars cited by the United States were not of American origin. Rather, they were European-origin vehicles, for example the Jaguar (imported from Great Britain by Ford) and the Cadillac Allante (imported from Italy by General Motors). In fact, there was no American-origin vehicle named by the United States that was subject to the gas guzzler tax in 1993, which continued to be paid almost entirely on imported European goods. Accordingly, the US figures supported the discriminatory impact of the tax.

3.121 The **United States** argued that the tax could not be characterized as "simply a device for raising revenue", although, in itself, revenue raising was not an objectionable government prerogative. While the increase of the gas guzzler tax rates was expected to raise revenue, its fuel efficiency goal could not be separated from the purpose of the measure. Data from industry, environmental groups, and other sources showed that the gas guzzler tax was largely responsible for the fact that nearly all passenger automobiles sold in the United States had fuel economies above 22.5 mpg. It was no coincidence that, over the past few years, manufacturers had raised the fuel economies of almost all domestic- and foreign-made automobiles above the gas guzzler tax threshold.

3.122 The EC's claim that market forces had "prevented" its manufacturers from improving the fuel economy of their least-efficient automobiles only highlighted that the tax had provided equivalent competitive opportunities to imports and domestic products, consistent with Article III. Despite its goal of improved fuel efficiency, the gas guzzler program did not prohibit the sale of fuel inefficient automobiles. Certain EC manufacturers chose to pay the tax instead of incurring the cost of fuel economy improvement, presumably their most economic option. To the extent there was some trade-off between fuel economy and other attributes desirable to consumers (such as acceleration performance), this decision may have also allowed these manufacturers to gain market share at the expense of complying manufacturers. To argue that EC automobile manufacturers could not easily modify their positions, ignored both the proven availability of fuel efficiency technologies and the abilities of most European manufacturers to produce fuel-efficient autos.

3.123 Nor was it the case that reliance on diesel engines prevented the EC manufacturers from complying with the program. Mercedes continued to market diesel engines in the United States. Although the popularity of diesel engines had decreased substantially from the early 1980's, domestic manufacturers suffered the deepest decline in diesel sales, yet were still able to meet gas

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guzzler requirements. Diesel sales had never been significant for BMW, which had relied on gasoline-fuelled engines which decreased in fuel economy after the early 1980s. The EC claimed that automobile manufacturers could not easily modify their positions, ignored both the state of current fuel-efficiency technologies and the abilities of most European manufacturers to produce more fuel-efficient autos. A comparison of Lexus LS400, a Japanese luxury car introduced in the US market in 1990, and 1991 BMW and Mercedes models of equal test weight and near equal size, indicated that Lexus had much better performance and better fuel economy because of technology features that the European cars did not have. It thus avoided the gas guzzler tax, while the BMW and Mercedes models did not. BMW and Mercedes, in many instances, did not even add the fuel-economy technology features that had been commonly employed in the largest American luxury cars, such as the Cadillac De Ville and Lincoln Continental between 1980 and 1990. Instead, during this period, their vehicles grew in weight and size. However, in their economic interest, European manufacturers could decide, and in some instances had already decided, to avoid the tax by changing their vehicles. Such decisions were consciously adopted and formed part of US marketing strategy.

3.124 The **European Community** argued that if a tax in order to protect the domestic environment had a disproportionate impact on imports, or if a tax category was created which impacted principally on imports, there was discrimination under Article III:2, first sentence. If imports were a disproportionate part of the problem, the environmental aspect would render the measure recognized by the criteria in Article XX(b) or (g). Under Article XX(g), for instance, it would be easier to show that any discrimination was not arbitrary and that the primary aim was to conserve natural resources, if it was evident that imports were a major cause of the destruction of natural resources. However, with only 4 per cent or less of the car market in the United States, European imports could not constitute a disproportionate part of the environmental problem.

3.125 The **United States** argued that the EC's interpretation would mean that the adoption of any mandatory standards in one contracting party that differed from the standard applied in another contracting party would violate Article III. It was difficult to imagine that the drafters of the General Agreement had intended this interpretation of Article III. Without prejudice to the debate on whether Article XX encompassed the full range of environmental measures, under the EC's scenario if imports were causing a disproportionate share of an environmental problem within the territory of a contracting party, and that problem was not within the areas covered by Article XX(b), XX(g), or any other Article XX provision, then that contracting party would have no GATT-consistent means of addressing the issue.

3.126 Moreover, as discussed in the context of the luxury tax, the United States considered that the arguments by the EC re-visited issues that were raised when the Agreement on Technical Barriers to Trade was being negotiated during the Tokyo Round. Standards were widely recognized as serving important public policy objectives, even though they often had a more adverse effect on imports than on domestic products. In recognition of the fact that standards by their nature often created obstacles to international trade, the drafters of the TBT Agreement sought to discipline only those standards that created an "unnecessary" obstacle to international trade. Had the consensus been that Article III already disciplined standards based only on their "adverse" effect on some imports, no separate agreement to supplement the General Agreement would have been necessary.

3.127 Article III permitted *de jure* neutral laws to differentiate between products for legitimate policy purposes, including to harmonize national standards, to force technological innovation for the purpose of fuel conservation and other economic policy objectives, to tax on a progressive basis, to protect the environment and to avoid the accumulation of wastes. In fact, under the TBT Agreement, contracting parties remained free to prohibit imports of products that did not comply

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with their technical regulations. This would create a far more "disproportionate" impact on imports than the measures at issue in this dispute, yet it had not been suggested that Article III would render all such technical regulations inconsistent with the General Agreement.

(b) Methodology for calculating the fuel economy

3.128 The **European Community** argued that because the implementing regulations of the US EPA and the US Department of Treasury permitted full-line US manufacturers greater flexibility to manipulate the application of the tax in accordance with the methodology described above, many American models, including some of America's best known car lines, escaped the tax, even though they consumed as much or more gasoline than like European vehicles that were subject to penalties. Accordingly, the gas guzzler tax violated the first sentence of Article III:2, and in addition afforded protection to like or directly competitive American vehicles in violation of Article III:2, second sentence.

3.129 Under the EPA methodology, the gas guzzler tax applied to "model types" that fell below 22.5 mpg in EPA fuel economy ratings. For domestic manufacturers, a model type was typically composed of vehicles in several different base levels which, in turn, were often formed from several different configurations and subconfigurations. A manufacturer that used the same basic engine, inertia weight class, and transmission class for several different models could average the fuel consumption of various vehicle configurations to mask low fuel economy ratings of some vehicles within the model type. This enabled manufacturers to meet or exceed the 22.5 mpg threshold for a model type, even if particular vehicle configurations within that model type did not meet the standard. Because American manufacturers had multiple vehicle configurations with a single basic engine and transmission class, they had the greatest opportunity to exploit this loophole and avoid gas guzzler penalties.

3.130 This model type averaging methodology discriminated against European manufacturers because domestic manufacturers were able to average together vehicle subconfiguration, configuration, and base levels with relatively wide differences in fuel economy values. For example, data from GM's own reports submitted to the US Government noted that the Chevrolet Corvette Convertible escaped the gas guzzler tax, even though the fuel economy of at least one vehicle configuration was only 20.6 mpg, well below the 22.5 mpg standard. This was because the Corvette's basic engine and transmission class were also used in other Corvette vehicle configurations and in other GM cars with higher fuel economy ratings, resulting in a weighted average for the model type above 22.5 mpg. Similarly, reports from Ford indicated that the Thunderbird and Mercury Cougar models with 21.6 mpg also escaped the gas guzzler tax.

3.131 The Big Three had historically covered their target market - mid-size and large vehicles - by offering numerous models for specific segments of that market. For example, Chevrolet, Buick, Oldsmobile, Cadillac, and Pontiac were all GM nameplates. GM achieved economies of scale by placing the same drivetrain on several different vehicle platforms, often with different outward features to attract different segments of the buying public. As a result vehicles in different carlines, and with significant variations in fuel economy, may actually be in the same subconfiguration, configuration, or base level.

3.132 As a result of the averaging methodology, numerous subconfigurations with fuel economies below 22.5 mpg - which represented vehicles that were like or directly competitive with European imports - were not subject to the gas guzzler tax. A hypothetical example was a situation where a US manufacturer had four different vehicle configurations within a single base level that was classified by EPA as a single model type. The actual fuel economies of the vehicles were 23.4, 21.8, 21.0 and 21.0 mpg. If the gas guzzler tax was intended to encourage fuel

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efficiency, one would expect that all but one of the vehicles would be subject to the tax. However, because the EPA regulations allowed the four vehicles to be grouped as a single model type fuel economy class and the domestic manufacturer was able to project production of each of the four vehicles, all four escaped the tax. The following chart illustrated this example:

Vehicle No.1	Vehicle No.2	Vehicle No.3	Vehicle No.4		Model Type
6,000 sales	2,000 sales	1,000 sales	1,000 sales		10,000 sales
(23.4 mpg)	(21.8 mpg)	(21.0 mpg)	(21.0 mpg)	=	22.6 mpg

3.133 The EC added that EPA reports for the 1991 model year indicated that many other carlines similarly avoided the gas guzzler tax, including the Pontiac Grand Prix, the Lincoln Town Car, and the Mercury Cougar. According to 1992 EPA data, more than twenty American car models did not meet the gas guzzler tax threshold, but were nevertheless exempted from the tax because their poor mileage ratings were averaged with other models using the same engine and transmission combination. These included some of the US best known car lines, including Corvette, Camaro, Mustang, and Town Car.

3.134 In contrast, due to European manufacturers' limited market, they were unable to use a single drive train for a number of different models. Model type calculations were relatively straightforward for the limited-line European manufacturers which, like Mercedes, BMW, Rolls-Royce, Porsche, Ferrari and Volvo, typically used one vehicle for each model type. In addition, most European producers could not afford to design, produce or market specialized configurations, subconfiguration, or base levels to manipulate the EPA regulations to avoid the gas guzzler tax. Although EPA required manufacturers to form a new subconfiguration and configuration when running changes were made to a vehicle during the certification process (for example, if a different set of tires were used), this differed from the subconfigurations and configurations of domestic manufacturers, which often contained vehicles with more significant variations in fuel economy performance.

3.135 Thus, model type averaging had the effect of imposing the gas guzzler tax on imported European vehicles while exempting American-origin automobiles with equivalent or inferior fuel economy. If the gas guzzler tax were a tax based on the fuel efficiency of each vehicle, then it would be protected by Article III. However, the tax employed an artificial methodology, that, by design and effect, allowed manufacturers such as the Big Three to avoid paying gas guzzler tax, even on their least fuel-efficient vehicles. The result was that thousands of US-made vehicles with fuel economy under 22.5 mpg paid no gas guzzler tax in 1992 while like European vehicles with identical fuel economy values were taxed.

3.136 The **United States** asserted that the model-type methodology used was trade neutral and was not designed to afford protection to domestic production. Based on the fact that this methodology, under certain conditions, permitted companies, both foreign[69] and domestic, to produce several configurations with varying fuel-efficiencies within a model type, the EC speculated that the entire methodology was designed to afford protection to domestic production, simply because some European manufacturers had chosen not to offer multiple configurations within a model type. The EC was basing a GATT complaint on the effect of a regulation on individual exporters, and appeared to be demanding that contracting parties be obliged to tailor their regulations to what was convenient to some of these exporters.

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[69]The United States noted that in model year 1993, some of the foreign manufacturers that had two or more model types averaged at or above 22.5 mpg (not gas guzzlers), but at least one test vehicle below 22.5 mpg, were Audi, Nissan, Porsche, Toyota and Volkswagen.

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3.137 Although the gas guzzler law required fuel economy values to be determined on a model type basis, the law did not dictate how these values were to be determined. EPA had previously established and implemented a definition of "model type" for use in the fuel economy labelling and CAFE programs. The definition was based on commonality of the physical characteristics of a vehicle that most influenced fuel consumption and were reasonably recognizable by consumers. Reliance on "model type" balanced two conflicting goals: (1) determining the most accurate fuel economy value for the individual car and (2) minimizing the amount of cost incurred by the auto manufacturers and the Government in testing vehicles and conducting the other aspects of the fuel economy program.

3.138 When EPA had decided to adopt this methodology for the gas guzzler calculation, EC manufacturers did not complain during the rulemaking proceedings that the methodology discriminated against them.[70] The United States was unaware of any instance since then when these manufacturers had made such a claim. A law or regulation's alleged imperfections would not in themselves create an inconsistency with the General Agreement, even with a "disproportionate" incidence on certain foreign manufacturers that allegedly resulted many years after the introduction of a program.

3.139 EPA retained this definition of "model type" for the gas guzzler regulations for several reasons. One was that the objective of the gas guzzler tax was similar to that of the fuel economy labelling program: to dissuade consumers from purchasing the least fuel-efficient vehicles, and consequently encourage manufacturers to respond by improving the fuel efficiency of these vehicles. Taxation on the basis of "model type" was predicated on generally predictable consumer and market activities and responses. The physical differences that distinguished model types were generally items that the consumer consciously selected when making a purchasing decision. The fuel economies of different model types of one manufacturer usually differed substantially. Moreover, model type was the basis on which consumers compared vehicles between manufacturers. More discrete subsets, such as configuration, separated vehicles on the basis of more technical differences, such as axle ratio, or engine or transmission calibration, which were less well understood by consumers and were not readily distinguishable by appearance.

3.140 The United States added that the goal of providing information to consumers in time to affect purchasing decisions inherently circumscribed regulatory options. It was not possible to test vehicles representing all the subconfigurations within a model type prior to model introduction, since manufacturers offered about 8,800 different vehicle subconfigurations annually to meet US market demands. By necessity, some vehicles were untested, and their fuel economy estimated by test results on other vehicle designs. EPA's model type averaging permitted determinations of model type fuel economy on the basis of data reasonably available prior to model introduction. Its methodology grouped vehicles of similar design, so that the fuel economy of all designs could be approximated by determining the fuel economy of one design within the model type group. Since not all designs within a model type were as popular or sold as much as other designs, the consumer was informed of "typically expected" fuel economy as based on the fuel economy of the highest-selling configuration within each base level within the model type.

3.141 The regulations required, for a model type containing one base level, that the manufacturer test the highest-selling configuration and the highest-selling subconfiguration within that configuration. If no more information on the fuel economy of other configurations was available, this configuration's fuel economy provided the best estimate of fuel economy for all designs within the model type. If more than one base level was available within that model type, then the highest-selling configuration (and subconfiguration) within each base level must be tested.

[70] 40 Fed. Reg. 5,162 (1980); Docket A-79-44.

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The base level fuel economy estimates were averaged according to sales within the model type to establish the best estimate of likely fuel efficiency for that model type. The concept of two different base levels within the model type generally recognized the influence on fuel economy of different inertia weights within the model type. If a model type contained vehicles which had simulated test weights differing by 500 pounds, the vehicles would be expected to have significantly different fuel economy test results. Thus vehicles in different base levels were expected to have significantly different fuel economy; this was the reason test data was required from each base level within a model type.

3.142 The fuel economy rules separated vehicles into different configurations and subconfigurations because of the potential that otherwise identical vehicles might have differences in fuel economy due to the difference in features such as axle ratio or engine calibration. However, such design differences did not necessarily result in differences in fuel economy. In many cases, configurations within a base level would get almost the same fuel economy, especially when estimated to the nearest mile-per-gallon, which is the case for the tax. This proximity of expected fuel economy test results was even likelier when comparing subconfigurations within a configuration. Requiring each subconfiguration to be tested separately for gas guzzler tax purposes was not technically justified, since in most cases, this approach would not change the gas guzzler status of a vehicle.

3.143 There were a few rare cases where different subconfigurations within a configuration had a more significant difference in fuel economy. For this reason, the regulations required that the highest-selling subconfiguration within the highest selling configuration be tested, and if additional subconfigurations were tested within the configuration, these data be sales-weighted to preclude any biasing of the calculated fuel economy estimate. While there was more potential for variability in fuel economy between two configurations than within one configuration, this likelihood was not so great as to warrant separate testing of all configurations within a model type. Accounting for more vehicle characteristics would dramatically raise testing burdens without providing commensurate benefits to consumers.

3.144 Multiple base levels within a model type presented a different situation. The expected differences in fuel economy between these base levels were so high that the fuel economy regulations required testing of all base levels within a model type. Because of sales weighting, the data from a relatively low-selling base level did not have a major impact on model type fuel economy. Also, additional data were often added beyond the minimum of one set per base level. Model type averaging would occasionally result in cases in which some vehicle configurations within a model type had test results below the gas guzzler threshold of 22.5 mpg, yet were in model types which had an average fuel economy at or above 22.5 mpg. Several US models, as well as models offered by Audi and Porsche, had included some configurations which had had test results below 22.5 mpg, but were not subject to tax because the model types had had test data which, when sales-weighted, had resulted in average fuel economy above this threshold. While there were no similar cases for Mercedes or BMW, they had had configurations with fuel economies below other gas guzzler thresholds with model type averages above these threshold; the effect was the same as above.

3.145 The United States added that analyses of configurations within model types that exceeded the threshold showed that sales of the configurations below 22.5 mpg represented a small proportion of their model type sales. For the 1993 model year, the configurations slightly below this threshold represented only 4.3 per cent of their model type sales on average. The sales-weighted average fuel economy of these configurations was 21.5 mpg. In contrast, the Mercedes and BMW vehicles below 22.5 mpg made up 100 per cent of the sales of the model types in which they were included. Every configuration offered by BMW and Mercedes was a gas guzzler

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with sales-weighted average fuel economy of 19.3 mpg and 18.9 mpg respectively. The comparison was similar for 1992. Therefore, changing the gas guzzler regulations to require testing at further levels of detail, would not lower the tax liability of these European car companies - in many instances it would increase it. Only corporate decisions (such as those announced publicly by Mercedes) could accomplish the law's goal of producing no model types below 22.5 mpg.

3.146 Aside from the fact that a complaint based on the competitive position of individual exporters was not within the province of the GATT, the EC's claim, that the ability to offset data from inefficient designs within a model was unique to domestic manufacturers, was untrue. In fact, the ability of manufacturers to offer multiple configurations within a model type was not unique to either full-line or limited-line manufacturers. Japanese and most European manufacturers also typically had several different vehicle configurations or subconfigurations in each model type. Indeed, most manufacturers offered between three and five configurations within a base level, regardless of the size of the manufacturer or number of model types they offered. Even BMW and Mercedes imported vehicles with different body designs (e.g. two-door, with or without sun roof), performance tires, and other options that could affect weight or drag. Only the very exotic sports automobile manufacturers offered so little variety to American consumers that model type fuel economy was not an average of several configurations.

3.147 There was no inherent reason why full-line manufacturers would offer more or fewer varieties of a particular model type than limited-line manufacturers. The latter may choose not to import vehicles with different fuel economy configurations, but not because they were forced into a "one design must fit all" marketing situation. Any manufacturer attempting to satisfy its perception of market demand might determine that more than one vehicle configuration was needed. Since manufacturers competed on, for example, a model type versus model type basis, the ability to sell multiple configurations within a model type should also not vary due to manufacturer's size. Therefore, the ability to average within a model type was equally available to all manufacturers. In fact, among competing luxury vehicles, offering multiple configurations did not play any significant role: Mercedes and BMW averaged one configuration per model type, Lincoln and Cadillac averaged 1.3 and Toyota 1.7 configurations per model type. Configuration averaging had not significantly affected the fuel economy values ascribed to luxury automobiles.

3.148 The averaging did not produce opportunities for gaming at the configuration and subconfiguration level because the regulations required test data from the subconfiguration and configuration levels with the highest projected sales within each base level affecting that model type. The regulations also allowed a manufacturer to voluntarily supply data on other vehicle configurations in the base level, but again, the highest selling subconfiguration had to be tested. Presumably, if a vehicle manufacturer had designed vehicles with a base level that, if tested, would demonstrate that the calculated model type average fuel economy would exceed the gas guzzler standard, the manufacturer would consider testing these vehicles. The regulations presumed that the calculated average for the model type fairly reflected the average fuel economy of all vehicles sold within the model type. It was hard to imagine what inherent advantage domestic manufacturers would have in manipulating the system at the configuration level.

3.149 The **European Community** acknowledged that there may be cases in which a rule designed for administrative convenience with an incidental disproportionate impact on imports may be acceptable. However, in this case, the averaging methodology had a profound discriminatory effect on imports and was at the crux of the *de facto* discrimination of this tax: it failed to provide equal treatment to like vehicles. As a result, tens of thousands of American-origin vehicles with fuel economies below 22.5 mpg paid no tax, while European vehicles with the same

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or better fuel economies were taxed. If the United States wished to penalize cars with lower fuel efficiency for energy or environmental reasons, it would, for example, tax gas guzzling TransAms, regardless of the fact that other TransAm subconfigurations had smaller engines and better fuel economy. The United States claim that model type averaging was justified by administrative convenience seriously contradicted the defense that the gas guzzler tax was purely an environmental measure.

3.150 The **United States** added that gas guzzler assessment was based upon model type fuel economy by statutory mandate, and not upon other possible alternative lines of product differentiation, such as vehicle configuration, engine displacement, interior volume or weight, all of which influenced fuel efficiency. For example, Germany had a tax based on engine displacement, which only had some influence on fuel economy, and was a far less accurate measure. Such a less accurate measure of fuel economy as engine displacement was sure to result in cases where a more fuel efficient vehicle was taxed at a higher rate than a less fuel efficient vehicle. The US Government considered model type a better basis for measuring fuel economy for the gas guzzler tax assessment and consumer information purposes than any of the alternative methods suggested by the EC for measuring fuel economy.

3.151 The EC was misguided in focusing on design characteristics that were not the target of the gas guzzler program, and its claim, that vehicles produced by American domestic manufacturers were escaping rightful payment of gas guzzler tax, was not to the point. The EC also ignored the fact that even within a model type, if a particular test result was below the gas guzzler threshold of 22.5 mpg, a model type would be "pulled" above that threshold only if the fuel economy and sales volume levels of other configurations were sufficiently high to offset the low fuel economy configuration. This condition of competition applied equally to imports and domestic products.

3.152 Furthermore, while there were some examples of an American model average exceeding the gas guzzler threshold, even though there was a configuration below the threshold, EPA knew of no example where an EC model type average was below 22.5 mpg but had vehicle configurations above 22.5 mpg; that meant that all EC manufacturer models designated as gas guzzlers indeed were gas guzzlers for all configurations sold in the United States. (The average fuel economy for Mercedes and BMW vehicles below the threshold was 19.7 mpg and 18.9 mpg, respectively.) In the 1993 model year, Porsche and Audi produced vehicle designs which individually were less fuel-efficient than 22.5 mpg, but were averaged with other data such that the model type average exceeded 22.5 mpg. The Porsche 968 with the A4 transmission and the 3-litre engine, had a model type combined fuel economy of 22.5565 mpg. The model type value was an average of subconfigurations which individually attained 22.8 and 22.3 mpg combined fuel economy. The Audi 90, with the L4, 2-mode transmission and the 2.8 litre engine, had a model type combined fuel economy of 22.5471 mpg. The model type value was an average of the two transmission modes that individually attained 23.1 and 22 mpg combined fuel economy.

3.153 Similarly, Mercedes and BMW had reduced gas guzzler tax liability by averaging within the model type. Since the gas guzzler tax assessment increased as vehicles fell into lower fuel economy brackets, it was to a manufacturer's benefit if one configuration fell, for example, below 19.5 mpg, while another was above that level, with the resulting model type average at or above 19.5 mpg. In such a case, all vehicles in the model type would be assessed a gas guzzler penalty of $2,100 per vehicle rather than $2,600 per vehicle for those configurations in the model type below 19.5 mpg. Since the 1989 model year, both BMW and Mercedes had benefitted from averaging in this way, reducing BMW's tax liability by about $6.7 million and Mercedes' potential liability by about $2.3 million.

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3.154 The United States noted that the EC had acknowledged that limited-line European manufacturers did not design their vehicles primarily with the US market in mind. The variety of automobiles within a model type offered to consumers was the result of marketing decisions made by manufacturers, not of CAFE or the gas guzzler tax. As the EC stated, "seemingly identical members of a model type may in fact represent different vehicle configurations" because the manufacturer desired to accommodate varying consumer preferences for power, performance, interior volume, and other attributes as well as fuel economy. Based on market factors and unwillingness to invest in technology to develop automobiles that would be both high performance and fuel-efficient, some of them chose to serve a part of the market subject to the tax.

(c) Light trucks

3.155 The **European Community** argued that the United States taxed European automobiles while exempting from gas guzzler tax many like or directly competitive American vehicles - namely minivans, sport-utility vehicles, and light pickup trucks. Because they were built and used to carry passengers, such vehicles were like products for the purposes of Article III:2, first sentence. If not, they certainly represented directly competitive or substitutable products for the purposes of Article III:2, second sentence, since the principal consumers of sport-utility vehicles and minivans were families choosing between such vehicles and station wagons or other large passenger automobiles. Also, such vehicles entered the United States under the Harmonized System tariff classification for "passenger vehicles". Because they were not subject to gas guzzler penalties, the tax provided a discriminatory competitive advantage to the US industry and harmed sales of directly competitive or substitutable imported European vehicles in violation of Article III:2.

3.156 The sport-utility segment of the US market was dominated by the traditional US manufacturers and was the fastest-growing sector of the US auto market consisting of, for example, the Ford Explorer and Jeep Grand Cherokee. The motivations of the Big Three in allocating resources to expand their light truck fleet was based on the preferential treatment light trucks received under the CAFE and the gas guzzler tax which significantly enhanced their marketability. These vehicles, including many of the most fuel-consuming ones on America's roads, were not subject to the gas guzzler tax because US manufacturers had successfully lobbied Congress not to impose on this lucrative and expanding segment of the market the same tax burden carried by European manufacturers. The consumer could purchase a vehicle with the interior space of a station wagon and the power and comfort generally associated with a luxury car without the burden of either tax. Thus, sales of light trucks permitted the Big Three to expand their market share for large vehicles without exposing themselves to the gas guzzler tax.

3.157 The **United States** noted that the ability to take advantage of growing demand for light trucks in the US market was available equally to importers and domestic producers. Indeed, the first minivans were produced by Volkswagen, many years before their recent popularity, and currently Volkswagen, Eurovan, the Range Rover and similar sport-utility and minivans from Asia were marketed in the United States. Imports and domestic products in the light truck category were treated equally under domestic laws and taxes, consistent with Article III.

3.158 The fact that light trucks were not subject to the tax was not evidence of protectionist design, but a recognition of technology limitations. They were not subject to the gas guzzler tax largely because when it was imposed, there was little use of light trucks in the US market, and they primarily included vehicles with unique cargo-carrying or commercial, work-related capabilities. In addition,at that time there were very few minivans in the US market, other than those produced by Volkswagen. The law tied application of the tax to the National Highway Traffic Safety Administration's (NHTSA) 1977 regulation's definition of passenger automobiles,

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which covered automobiles manufactured for the transportation of not more than ten individuals and excluded automobiles capable of off-highway operation.[71]

3.159 There remained considerable technical difficulties in this vehicle segment achieving fuel economy while at the same time serving other functional purposes. Moreover, the fuel efficiency of passenger cars ranged from about 15 to 50 mpg while light trucks had a much narrower range. Light trucks were subject to CAFE requirements, but at a lower level - the maximum feasible average fuel economy level for such vehicles. Moreover, while the least fuel efficient cars had poor economy because of high performance (acceleration and luxury features), this was generally less true for light trucks. They typically had lower fuel economy because of attributes related to the work they performed.

3.160 The **European Community** argued that an analysis of the light truck market showed that American consumers, the automobile industry, and even the US Government considered light trucks to be passenger vehicles, as opposed to work vehicles. In its 1991 report on automotive fuel economy prepared for the US Government, the National Research Council, the research arm of the National Academy of Sciences, stated:

> The rapid expansion of light trucks as a proportion of market share has not been accompanied by a clear understanding of their use. They now represent close to one-third of the market, and according to the industry, about 70 per cent are purchased for personal rather than commercial use. In effect, light trucks are being used as a substitute for the passenger car. In the past, however, light trucks have not been subject to the same standards as passenger cars for safety (or fuel economy) ... Because they have become such a significant portion of the passenger-vehicle fleet, more aggressive efforts to improve the safety and fuel economy of light trucks should be taken. Otherwise, any gains made through improvements in passenger cars may be offset by the increased use of light trucks.

3.161 The US Government had acknowledged this trend. According to the Office of Technology Assessment, the research arm of the US Congress, "light trucks are used more as passenger vehicles than as freight haulers, making them legitimately part of a light-duty passenger fleet".[72] This development also was readily acknowledged in a recent article.[73] Also, the National Highway Traffic Safety Administration, the agency responsible for protecting the safety of motorists and their passengers, was in the process of requiring the same passenger safety standards for light trucks as for passenger cars, in recognition of the increased use of light trucks as passenger-carrying vehicles.

3.162 The **United States** added that while it was true that many light trucks were used for personal transportation, light trucks of most types and sizes were more typically used for commercial purposes, and therefore had to be designed accordingly, irrespective of their

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[71]49 C.F.R. 523.4. Automobiles capable of off-highway operation included an automobile with 4-wheel drive, a rating of more than 6,000 pounds gross vehicle weight, and other characteristics. C.F.R. 523.5(b).

[72]United States Congress, Office of Technology Assessment, *Improving Automobile Fuel Economy: New Standards, New Approaches*, OTA-E-504 (Oct. 1991), pg. 32.

[73]This article stated, "Recent technological advances have made [light-duty trucks] as easy to drive as an ordinary passenger car, as comfortable to ride in as a passenger car, and more convenient in terms of carrying space. Where once station wagons were the standard fare for suburban families, it's now utility vehicles and, especially in the last couple of years, vans. Where compact cars were what was largely seen in cities, now small pickup trucks are commonplace ... Eventually, some industry experts predict, as much as 40 per cent - almost half - of the vehicles on the road will be light trucks, vans and utility vehicles ... Indeed, there are a lot more light trucks and off-road vehicles in up-scale suburban communities like Chevy Chase, MD, than construction workers or back roads. Instead, the majority of the owners of such vehicles use them in exactly the same way they would use a car ... Phil Katcher, *Where is the Market Going?*, Automotive Marketing, June 1993, pg. 47.

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additional use as passenger vehicles. They were equipped to carry large cargo, and the technology that enabled them to be used for this constrained their fuel efficiency. For example, in order for a van to be able to carry large items inside, it had to have a large interior, and therefore, a large exterior. As a result, the van would have increased frontal area (increased aerodynamic drag, which lowered fuel economy) and would weigh more (which also lowered fuel economy). In addition, to have the acceleration capability to operate in traffic when heavily loaded, the vehicle would have to have lower gearing and/or a larger and more powerful engine, both of which reduced fuel economy. Many light trucks were also equipped with four-wheel drive, adding weight and friction losses, which reduced fuel economy, or other features enabling off-road operation (such as heavy duty chassis and suspension to withstand harsh impacts). Other technological features included, for example, truck tires that tended to be larger than passenger vehicle tires and had tread designs ideal for load carrying and off-road operation, but which reduced on-road fuel efficiency.

3.163 The **European Community** considered that the US contention that attributes related to the work that light trucks performed lowered fuel economy, ignored the fact that the vast majority of light trucks performed the same work that passenger cars performed: transporting individuals and families. The US assertion, that "technology limitations" precluded applying gas guzzler tax to these vehicles, was inconsistent with the application of CAFE to these vehicles (although at a lower rate than other passenger vehicles). The United States did not provide any explanation of why the gas guzzler tax should not also be applied. If the emphasis of the gas guzzler tax truly was to reduce the demand for vehicles with poor fuel economy, then light trucks should be the most important target rather than an excluded category. The United States was implying that these vehicles could not be large and still meet the 22.5 mpg threshold. However, if this was as true for large passenger cars as it was for light trucks, European high-performance vehicles would be exempt from the tax because their fuel economy was low for the same reasons that the fuel economy of light trucks was low, namely weight.

3.164 In accordance with the Note Ad Article III, light trucks and passenger cars were directly competitive and substitutable. Consumers utilized them interchangeably, and manufacturers' advertising was directed at the same consumer market. Yet light trucks - the market segment dominated by domestic manufacturers - received preferred tax treatment which provided domestic manufacturers with a competitive advantage. Moreover, sales of light trucks allowed the Big Three to expand their market share for large passenger vehicles without exposing themselves to the gas guzzler tax. GATT did not permit such discrimination.

3.165 The **United States** acknowledged that downsizing could be used to reduce vehicle weight and improve fuel efficiency of light trucks. The technological and economic feasibility of this was evident in the emerging popularity of small (as opposed to full size) pickup trucks and minivans. (A substantial number of minivans were used for commercial, cargo-carrying purposes). The popularity of these vehicles was due to their generally lower purchase price and lower operating cost (due in large part to their higher fuel efficiency). In the commercial vehicle market, where price and operating costs directly related to profitability, the economic incentives already in place promoted choice of the more fuel-efficient options. The ability of a gas guzzler tax program to further encourage fuel efficiency improvements without degrading utility would be very limited.

3.166 Although downsizing, as a means for reducing weight and improving fuel efficiency, was satisfactory in some cases, it was totally unsatisfactory in others where only a large pickup would be satisfactory. Also manufacturers often produced passenger van and cargo van versions of the same vehicles. They would not be able to continue this practice if they had to downsize cargo van versions as well as passenger versions. Since the goal of the gas guzzler program was to improve fuel efficiency without unacceptable loss in utility, it would be inconsistent to force sales of small

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pickup trucks or minivans when important utility was sacrificed. This would not achieve the intended energy efficiency; using two small pickup trucks, for example, to carry the load of one full-size pickup truck would be neither economically- nor energy- efficient.

3.167 Even without downsizing, additional fuel efficiency gains through weight reduction may be possible, but they would rely on reducing the vehicle's weight through the use of lighter weight materials of equal durability and strength. Considerable research was underway to examine composite materials and innovative construction techniques, but such technologies were not yet commercially available, and it was more likely they would see their first application in passenger automobiles than in light trucks.

3.168 Other than weight reduction, fuel efficiency improvement for light trucks could be possible from the gas guzzler tax program if trucks had not had the same types of engine and driveline refinements which had boosted the fuel efficiency of passenger cars. In general, since light trucks had also been subject to technology-forcing fuel economy standards through the CAFE program, they also had experienced similar types of refinements in their engines and drivelines. This was demonstrated in the following table:

Weight and Fuel Efficiency Gains for Light Trucks, 1975-93

Year	Weight	Fuel Efficiency Using Actual Weight Mix	Fuel Efficiency Using 1978 Weight Mix
1975	4072	13.7	13.3
1993	4125	20.8	20.6
% change	1.3%	51.8%	54.9%

Even though light trucks in 1993 were on average slightly heavier than in 1975, their average fuel efficiency had improved almost 52 per cent. The last column recalculated the fuel efficiency of the 1993 light truck fleet, assuming the same weight mix as in 1975. For the same weight mix of vehicles, light truck fuel efficiency had increased almost 55 per cent due to technological improvements in engine design and other features.

3.169 The United States added that unlike the passenger car market, where some luxury cars continued to be manufactured without maximizing fuel economy technology, there did not appear to be a "guzzler" market in the light truck category. The CAFE standards alone had resulted in the widespread use of fuel economy technology in this market. Light truck automatic transmissions incorporated lockup torque converters on 98.5 per cent of cars with automatic transmissions, while passenger cars used the lockup on 93.1 per cent. While 76.9 per cent of passenger cars used automatic transmissions, 76.3 per cent of light trucks did. All passenger cars used fuel injection in model year 1993, while 99 per cent of light trucks did. The average total fuel consumption per pound of vehicle weight of passenger cars was $1.08 \text{ X } 10^5$ gal./mi./lb. while that for light trucks was only slightly more, $1.15 \text{ x } 10^5$. Thus, imposition of the gas guzzler tax would be expected to have very limited fuel efficiency benefit, and could cause serious distortions in the market.

3.170 Fuel economy data showed that the light trucks with the lower fuel economy tended not to be minivans, but mostly large vans and full-size pickups. Even if minivans and sports utility vehicles were treated separately from other types of light trucks, it was not clear that significant improvements in minivan fuel economy would be achieved from a gas guzzler tax. Most minivans achieved about the same fuel economy, with an average just above 22 mpg. The worst designs, representing less than 10 per cent of minivan sales, achieved a fuel economy level only a

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few miles per gallon less than 22.5 mpg. (One of the lowest fuel economies was that of Range Rover, a sports utility vehicle imported from the United Kingdom, which had a fuel economy of 15.0 mpg). The relatively narrow range of fuel economy achieved by the vast majority of minivans suggested there were very few designs that could significantly improve fuel economy only by using technology and design features common to such vehicles. This fact *alone* distinguished such vehicles from the least fuel-efficient automobiles (which could be improved through technological improvements), and warranted different treatment as a matter of policy.

3.171 Moreover, in the context of Article III:2, minivans and sports-utility vehicles were not "like products" to the kinds of luxury automobiles exported by Mercedes and BMW. The US International Trade Commission, an independent governmental agency, found in an antidumping investigation in 1992 that, if anything, there was only a degree of substitutability on the demand side even between certain minivans and certain station wagons, full-size vans and sports-utility vehicles. The ITC found that as a whole "minivans as a product category fill a market niche that is only partially served by even these other vehicles".[74] Minivans and sports utility vehicles, in the price range of $15,000 to $25,000, did not compete with the gas guzzling vehicles produced by BMW and Mercedes: marketing data showed that in the United States, consumers selected automobiles from within a price range of about 15 per cent.

(d) Like product

3.172 The **European Community** noted that Article III:2, first sentence, prohibited a contracting party from imposing "internal taxes or other internal charges of any kind in excess of those applied, directly or indirectly, to like domestic products". Further, *Japan - Alcoholic beverages* had adopted a two-step procedure for examining the conformity of internal taxes with Article III:2 by "determining, firstly, whether the taxed imported and domestic products were 'like' or 'directly competitive or substitutable' and, secondly whether the taxation was discriminatory (first sentence) or protective (second sentence of Article III:2)".[75]

3.173 For the same reasons given for the luxury tax, all automobiles represented a single "like product" for purposes of Article III. The issue was therefore whether the United States had impermissibly discriminated against imported European autos by imposing a gas guzzler tax on them, while exempting like domestic products.

3.174 Prohibition against tax discrimination was strict. The Panel on *Japan - Alcoholic beverages* noted that by using the words "internal taxes ... of any kind", the contracting parties indicated that in assessing tax discrimination, "account was to be taken not only of the rate of the applicable internal tax, but also of the taxation methods (different kinds of internal taxes, direct taxation of the finished product or indirect taxation by taxing the raw material used in the product during the various stages of production) and of the rules for the tax collection (e.g. basis of assessment)".[76]

3.175 As discussed under luxury taxes, GATT also recognized that an internal tax could violate Article III:2, second sentence, by disrupting competition between directly competitive or substitutable products so as to afford protection to domestic production, contrary to the principles of Article III, paragraph 1. In a closely analogous situation where the United States faced a French tax on American automobiles in 1956, the United States had explained why Article III:2,

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[74]Minivans from Japan, Inv. No. 731-TA-522, USITC Pub. 2529, July 1992, pg. 5.

[75]BISD 34S/83, para. 5.5.

[76]*Id* at para. 5.8.

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second sentence, prohibited a contracting party from singling out particular categories of vehicles for disproportionate and discriminatory tax burdens:

> The French Chamber of Deputies, as part of the National Solidarity Fund Bill, recently authorized the imposition of a 100,000 franc annual tax on automobiles and station wagons having a power rating for fiscal purposes in excess of 16 horsepower. This tax applied to cars registered in France after 1 January 1950. Since French production of automobiles of more than 16 fiscal horsepower is negligible, the tax falls almost exclusively on imported cars, and on United States makes in particular. The United States considers that the particular burden on United States automobiles in comparison with French cars is contrary to the principles set forth in the first paragraph of Article III of the General Agreement, which is made an obligation by the second sentence of the second paragraph.[77]

3.176 This US position was also applicable to the gas guzzler tax which had in fact upset existing competitive relationships between domestic and European cars in at least three respects:

- the tax had given American automobiles not subject to the tax a competitive advantage. Since all automobiles were directly competitive or substitutable products serving the same function, the imposition of a tax on certain imported automobiles, but not on domestic models, inevitably disrupted competition. In this case, the doubling of the gas guzzler tax in the 1990 Budget Act had contributed to a sharp decline in sales of European autos;

- to the extent that the Big Three had been able to circumvent the tax through "averaging", the tax disrupted competition between imported and domestic fuel-intensive vehicles. Thus, for a consumer seeking a high-performance vehicle, exempting domestic models with the same or higher fuel consumption than European models provided US producers with a competitive edge, and afforded protection to American auto production;

- because light trucks and "mini-vans" were not subject to the gas guzzler tax, the tax upset existing competitive relationships between European automobiles and directly competitive US sports-utility vehicles.

3.177 The **United States** argued that, given that the gas guzzler tax applied equally to imports and domestic products, European automobiles that failed to meet the applicable threshold were treated the same as domestic products not meeting the threshold. Under GATT drafting history and precedent (as described in the context of the luxury tax, above), automobiles not meeting the threshold and automobiles with acceptable fuel efficiency were not to be treated as "like products" under Article III:2, and taxing one and not the other was not inconsistent with that provision. However "like" automobiles may be for tariff purposes, they were not "like products" if they had different fuel efficiency capacities as defined in a law intended to discourage the manufacture of very fuel inefficient vehicles. The Article III requirement was addressed to "relative competitive opportunities created by the government in the market, not the actual choices made by enterprises in that market".[78] While the EC agreed that Article III permitted contracting parties to make regulatory distinctions between similar products, its arguments failed to acknowledge that none of the regulatory distinctions in the gas guzzler program impaired the equal competitive opportunities

[77]GATT Analytical Index, Article III-10, L/520 12 September 1956; see also GATT Doc. L/599, 16 November 1956 (U.S. objection to Chilean tax on automobiles).

[78]Report of the Panel on *United States - Measures affecting alcoholic and malt beverages*, adopted on 19 June 1992, BISD 39S/206, para. 5.30.

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available to imports and domestic products. No aspect of the gas guzzler program was applied to afford protection to domestic production, and it was therefore consistent with Article III.

3.178 The nature of the above dispute with France highlighted the difference between the EC's arguments here and a true case of discrimination under a *de jure* neutral law inconsistent with Article III. In that case, France's auto tax structure, which was based on a horsepower/weight formula rose very sharply at the point where the formula separated French and American models, making it considerably more expensive to own an American auto. Debates in the French Parliament revealed that the formula had been chosen with this result in mind. France had defended the measure on the allegation that wealthier individuals drove cars with higher horsepower and weight.[79]

3.179 This case contrasted with the legitimate measures at issue in this dispute. The gas guzzler tax was not based on immutable characteristics of the regulated products; nor did it involve a drastic transition or radically different tax treatment for a product once it crossed the regulatory threshold. It applied on a graduated basis. Furthermore, the discussion by the CONTRACTING PARTIES of the US claim against France's auto tax structure had resulted in an impasse over the legal issues. This was only further evidence that the EC's assumption, that "disproportionate incidence" was highly probative of discrimination, was not one adopted by the CONTRACTING PARTIES. Ultimately, the European Court of Justice addressed France's system in the context of Article 95 of the Treaty of Rome, a provision almost identical to GATT Article III:2. It found that this was a special fixed tax on a category of imports only, was too great and presented too abrupt a transition, therefore the tax was protective and discriminatory.[80]

3.180 All the distinctions in the gas guzzler program cited by the EC as inconsistent with Article III in fact were objective and based on legitimate regulatory and policy concerns. None involved the kinds of exceptional distinctions at issue in the *Japan - Alcoholic beverages* dispute. European luxury vehicles were able to improve their fuel economy if they chose to, and meet the 22.5 mpg threshold; they were able to exploit any aspect of EPA's calculation methodology that provided an alleged competitive advantage; and they could market light trucks in response to rising US consumer demand. Their failed response in the US market, and their current complaints, amounted to actual choices made by enterprises in the market; they did not make the gas guzzler tax inconsistent with Article III.

(d)(i) Objectivity of criteria

3.181 The **European Community** considered that to justify differences in the taxation of imported and domestic like products, a contracting party had to show that any disparity arose from legitimate, objective tax criteria. Article III was designed to prevent the selective application of taxes in ways that singled out imported products for excessive tax burdens. To meet the requirements of Article III:2, any differences in the application of an internal tax must be part of a trade-neutral system that taxed all products equally. Any tax categories used to classify goods for tax purposes had to be based on objective product differentiations.[81]

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[79]R.E. Hudec, *Enforcing International Trade Law: The Evolution of the Modern GATT Legal System* (1983), pg. 438.

[80]Case 112/84, Humblot v. Directeur des Services fiscaux, 1985, E.C.R. 1367 (1985). The United States added that the ECJ had created a judicial exception to Article 95, under which the prohibition of discriminatory taxes did not prevent states from adopting a system of taxes that increase progressively according to an objective criterion, provided that the system pursued economic policy objectives which were themselves compatible with Treaty requirements. Such compatible objectives included heavier taxation of luxury products or vehicles with high fuel consumption.

[81]BISD 34S/83, para. 5.9(a).

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3.182 The United States did not have a general, trade-neutral system for taxing vehicles according to gasoline consumption. If US policy were to limit consumption of gasoline, it would be entirely legitimate to apply a graduated tax that corresponded to the respective gasoline consumption of each vehicle. This tax would be trade-neutral, since vehicles with lower fuel consumption would pay a lower tax, while those with higher fuel consumption would pay a higher tax.

3.183 The **United States** noted that when originally promulgated, it was American cars that were least likely to meet the 22.5 mpg threshold; thus, the threshold did not target European imports. In addition, the gas guzzler tax approximated the type of measure that even the EC said it considered could meet the requirements of Article III. It was applied on the basis of an objective product differentiation, fuel economy. The tax was also a graduated system, with the least fuel-efficient cars (lower than 12.5 mpg), subject to the current maximum $7,700 tax, and cars just below 22.5 mpg only subject to $1,000 tax. There was no reason to tax all cars, as the EC proposed as the only means consistent with Article III, when many cars met the acceptable threshold. In the EC's example of emissions standards, there would be no reason why a government should be required to tax products meeting the standards, since this would take away the incentive for manufacturers to develop the technology to meet the standard.

3.184 Moreover, as described with respect to the luxury tax, the United States rejected the EC's proposed two-part test to be applied to analyze *de jure* neutral measures. The US analysis of whether a *de jure* neutral measure was consistent with Article III was derived from the purpose and language of Article III itself, and based on the discussions set forth in the few Panel reports that had been faced with the issue. However, as a practical matter, the EC's proposed test ignored the policy concerns that necessarily came to play in regulatory differentiation between products, as well as the purpose of Article III, which was that measures not be applied so as to afford protection to domestic production. Under the EC's proposed test, a measure that distinguished on the basis of an arbitrary physical characteristic, such as horsepower, would be consistent with the General Agreement even if applied to protect domestic production, so long as it was applied on a "comprehensive" basis. At the same time, the EC test would force contracting parties to apply a tax to all vehicles, and deny contracting parties the governmental prerogative of exempting products that complied with fuel economy regulations. The US analysis of this situation, focusing on the legitimacy of the policy objective (fuel conservation), and the objectivity of the criterion (a performance characteristic), gave proper weight to the real concern of Article III against the protection of domestic production.

3.185 The **European Community** argued that the 22.5 mpg threshold did not have a rational basis in tax or energy policy. As the Congressional Budget Office reported in 1992: "The gas guzzler tax applied mainly to the more expensive vehicles and, hence, falls on higher-income drivers. Little fuel conservation results from the tax, because it applies to a small percentage of vehicles and because the demand for expensive cars is not particularly responsive to the magnitude in the change of price that the tax causes".[82] Further, the 22.5 mpg threshold had no scientific basis. Despite major advances in automotive technology, the threshold had been maintained for over a decade at 22.5 mpg, principally because any tightening of the threshold to further promote energy conservation would also have the effect of subjecting large numbers of domestic vehicles to the tax. For CAFE, the United States required an overall fleet "average" for all imported or domestic passenger cars of 27.5 mpg. If the gas guzzler tax had been designed to penalize cars with "below-average" fuel economy, it would have been set at a significantly higher threshold, e.g. 27.5 mpg. Alternatively, the tax could have been set in terms of the maximum level of

[82]"Reducing the Deficit: Spending and Revenue Options", Congressional Budget Office (Report to the Senate and the House Committees on the Budget), February 1992, pg. 352.

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attainable fuel economy for individual motor vehicles. This would ensure that like vehicles with the same mpg would incur the same penalty.

3.186 While there were rational public policy reasons for encouraging energy conservation, the gas guzzler tax used an artificial threshold to ensure that primarily European automobiles were taxed, not like or directly competitive, domestically produced vehicles with comparable or lower fuel economies. Three facts illustrated that the 22.5 mpg threshold had no legitimate rationale in energy, environmental, or tax policy:

- the threshold affected just 0.7 per cent of the vehicles sold in the United States, 85 per cent of which were imported according to the Luckey study; if the tax were truly aimed at conserving fuel, it would have cast a wider net;

- despite the professed concern for energy conservation, the United States permitted the gas guzzler tax-free sale of thousands of like, domestically built passenger cars with fuel economies less than 22.5 mpg due to the calculation methodology;

- the United States had never imposed a gas guzzler tax on directly competitive (and highly popular) minivans, pickup trucks, and sports-utility vehicles, even though they performed the same passenger transportation purpose and consumed even greater amounts of fuel than large passenger cars. According to EPA, minivans, pickup trucks, and sports-utility vehicles constituted 34 per cent of American passenger vehicle sales in 1993 but consumed 40 per cent of the gasoline attributable to passenger vehicles.[83]

3.187 The **United States** argued that accepting the EC's arguments about thresholds would invalidate almost all thresholds. It was in the nature of continua of product performance (such as a listing of all new cars in ascending order of fuel economy) and of thresholds that items just above any threshold were likely not to differ materially from items just below the threshold. There was no single inherently appropriate point along the continuum at which the threshold should be set, and it could reasonably be set anywhere within a range of values along the continuum, depending largely upon a legislative balancing of technical and policy factors. These included, for example, technological feasibility, costs, degree of conservation desired, effects on product utility and opportunity costs (whether equal or greater benefits could be obtained in another way at less cost). Furthermore, determination of the appropriate level of conservation was properly left to each contracting party. Moreover, the 22.5 mpg threshold certainly had a more reasonable basis in fuel conservation policies than taxes based on horsepower levels or engine displacement, prevalent in the EC Member States, which were only tenuously connected to fuel conservation levels.

3.188 If a contracting party could argue that a threshold was arbitrary because of a lack of substantial differences immediately above and below the threshold, any threshold could be accused of being arbitrary, whether for a safety or environmental standard, or for the level at which a particular graduated tax took effect. The implications of this would preclude a vast variety of health and other regulations, where policy dictated that a cutoff be established somewhere.

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[83]*Environmental Protection Agency Technical Report: Light-Duty Automotive Technology and Fuel Economy Trends Through 1993*, May 1993, pg. 5 and 25. The European Community added that the American Council for an Energy-Efficient Economy also recognized this disparity, noting "the increasing share of light trucks with their poorer fuel economy" was a significant factor in the United States Government's failure to reduce overall fuel consumption. *Options for Reducing Oil Use by Light Vehicles: An Analysis of Technologies and Policy* (Dec. 1991), pg. 34.

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3.189 The current gas guzzler tax was not so different from many of the health and safety standards set high enough to prohibit the worst performers, but required no change from most of the products subject to those standards. The difference, critical to evaluating this dispute, was that this measure did not deny market access to the worst performers, but expected the market to discourage sales. The United States could have, but did not, prohibit the sale of cars with fuel economies below 22.5 mpg; it opted for the market-oriented solution.

3.190 Moreover the threshold was well grounded in US fuel economy policy, since it was established in direct proportion to CAFE requirements. The goal of the US Congress was to penalize technological laggards by setting standards that were estimated to be achievable, without eliminating any particular category of vehicle. Proof that the standard could be met by full-size luxury vehicles was that the vast majority of Cadillacs and Lincolns now avoided the tax. It had been responsible for pushing the average fuel efficiency of the least fuel-efficient cars above the threshold.

3.191 The gas guzzler tax was a reasonable measure, phased in at gradually higher fuel economy levels as CAFE requirements were raised to encourage manufacturers to improve the fuel economy of their least fuel-efficient automobiles. This was precisely the pattern followed by American automakers. The US Congress intended for the tax threshold to be set at 4 to 6.5 mpg below the applicable CAFE standard for any given year,[84] because compared to a vehicle with a fuel efficiency rating of 27.5 mpg, a vehicle with a 22.5 mpg rating (the threshold since 1986) consumed, on average, more than 800 additional gallons of gasoline over its lifetime. Improving the fuel efficiency of a fuel-inefficient vehicle had a greater impact on fuel conservation than the same one mile per gallon improvement in a relatively more fuel efficient vehicle. Consequently, when the gas guzzler program was established, it targeted the over 75 per cent of passenger vehicles with less than 22.5 mpg. The fact that fewer than one per cent of all vehicles in the U.S. market now failed to meet this threshold demonstrated the success of the gas guzzler program and other fuel conservation measures adopted by the United States.

3.192 When the US Congress increased the gas guzzler tax in 1990, it was reenforcing a policy against manufacturing fuel-inefficient automobiles for the American market that had been discouraged for over a decade. Such an increase in tax rates was not unusual since the tax rates were not originally indexed for inflation. As stated in the original legislative history of the Energy Tax Act, "if individuals are to be permitted to purchase inefficient automobiles and detract from the conservation effort made by most others, they should as matter of equity pay a considerable premium (in the form of a gas guzzler tax) for this privilege".[85]

3.193 The **European Community** argued that it did not need to demonstrate that the gas guzzler threshold was inherently discriminatory because it had established a *prima facie* case of discrimination by the effect of the tax, which was disproportionately higher on European cars than on US cars. In addition, it had demonstrated that the 22.5 mpg threshold did not have any legitimate scientific, energy, or environmental rationale.

(ii) Article XX(g)

3.194 The **European Community** noted that Article XX(g) was an exception to GATT obligations and that under GATT practice, the United States had the burden of establishing its right to implement discriminatory taxes that violated Article III. As the Panel on *United States - restrictions on imports of tuna* emphasized, "The practice of panels has been to interpret

[84]H.R. Conf. Rep. 1773, pg. 45.

[85]H. Rep. No. 496, the Cong. 1st Sess., pt.3, pg. 48-9 (1977).

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Article XX narrowly, to place the burden on the party invoking Article XX to justify its invocation, and not to examine Article XX exceptions unless invoked".[86]

3.195 The Panel on *United States - Prohibition of imports of tuna and tuna products from Canada* applied a four-part test to efforts by a contracting party to invoke Article XX(g). The Panel considered whether the alleged conservation measure: (1) was applied in a manner which would constitute arbitrary or unjustifiable discrimination; (2) represented a disguised restriction on international trade, (3) related to the conservation of an exhaustible natural resource, and (4) was made effective in conjunction with restrictions on domestic production or consumption.[87] The gas guzzler tax failed each of these tests.

3.196 The **United States** argued that the EC had not, and indeed could not, establish that the gas guzzler tax was inconsistent with Article III of the General Agreement. Accordingly, there was no need for the Panel to consider the applicability of Article XX to this measure. However, it was obvious from the facts presented above that the gas guzzler tax was also a measure within the scope of Article XX(g). It was a complement to the CAFE measures, and its application to imported vehicles was primarily aimed at rendering effective the restrictions on domestic production or consumption under the gas guzzler tax. The points discussed below were also relevant to the issue.

(a) Relating to the conservation of an exhaustible natural resource

3.197 The **European Community** noted that the Panel on *Canada - Measures affecting exports of unprocessed herring and salmon*, concluded that "while a trade measure did not have to be necessary or essential to the conservation of an exhaustible natural resource, it had to be primarily aimed at the conservation of an exhaustible natural resource to be considered as 'relating to' conservation within the meaning of Article XX(g).[88] This Panel also determined that a trade measure had to be designed principally to render effective domestic restrictions on production or consumption. A trade measure could therefore only be considered to be made effective 'in conjunction with' production restrictions if it was primarily aimed at rendering effective these restrictions.[89] A clear relationship had to be demonstrated between the measure and the alleged objective of conserving an exhaustible natural resource and making effective its domestic production or consumption restrictions. This requirement was crucial for GATT purposes, otherwise Article XX(g) would offer a loophole for any contracting party willing to implement protectionist trade restrictions on the basis of a tenuous connection to protecting the environment.

3.198 The gas guzzler tax could not be considered as "primarily aimed" at conservation of carbon fuels. The tax had long since become a revenue measure designed to fund domestic programs favoured by the US Congress and Administration. Its advantage was that it fell primarily on imported goods and had almost no effect on American auto production or employment. (This created a clear risk that the tax would increase in the future, since imported cars had little or no political constituency in the US Congress). This purpose was corroborated by the exclusion of light trucks, which substantially undermined the purported energy conservation goal of discouraging sales of vehicles with excessive fuel consumption. Their exclusion from the gas guzzler tax should refute the US argument that the tax was truly designed for environmental purposes. If it were, it would cover such vehicles - the fastest growing segment of the American

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[86]Not adopted, 3 September 1991, BISD 38S/155, para. 5.22.

[87]BISD 29S/105, paras. 4.8 - 4.14.

[88]Panel report adopted on 22 March 1988, BISD 35S/98, para. 4.6.

[89]*Id* at para. 4.6.

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market. There was a staggering energy and environmental cost in excluding these gas-guzzling vehicles.

3.199 It was important to note that the United States had provided no environmental justification for the preferential treatment of light trucks. In fact, the preference undermined the US assertion that the gas guzzler tax "reflect[s] a long-term energy conservation policy to discourage the production of fuel-inefficient automobiles" because it encouraged manufacturers to emphasize sales of light trucks over large cars, which often attained better fuel economy. Clearly, the gas guzzler exemption for light trucks served no legitimate environmental objective, and thus constituted arbitrary and unjustifiable discrimination under Article XX(g).

3.200 The **United States** argued that it was clear from the genesis of, and experience under, the gas guzzler tax that it was primarily aimed at fuel conservation. By creating incentives for shifting manufacturing and purchasing practices toward more fuel-efficient vehicles, the gas guzzler tax had increased fuel efficiency across the board and directly resulted in fuel conservation. As a result of the gas guzzler tax, US manufacturers had increased the fuel efficiency of all their models, including their largest, most fuel-inefficient vehicles, which had, in turn, decreased fuel consumption in the United States. Improving the fuel efficiency of passenger vehicles with the worst fuel economy had the greatest impact on fuel conservation. Although in 1978 over 75 per cent of passenger cars fell below the 22.5 mpg threshold, the fact that less than one per cent of all passenger vehicles now sold in the United States failed this threshold was adequate demonstration of the conservation purpose and success of the program.

3.201 With reference to the EC claim that the gas guzzler tax was now primarily aimed to raise revenue and that "it fell primarily on imported goods and had almost no effect on American auto production or employment", the fact that only certain manufacturers (including some US manufacturers) persisted in producing gas guzzlers did not alter the primary purpose of this tax: to promote increased fuel efficiency of the least-efficient automobiles. On the contrary, the gas guzzler tax was a success because it caused manufacturers to raise the fuel efficiency of their vehicles above this minimal level. The tax had succeeded in inducing most American manufacturers to refrain from producing automobiles below the 22.5 mpg threshold. The tax was doubled in 1990 because the previous levels, adopted twelve years earlier, no longer appeared sufficient to discourage production of the remaining gas guzzlers, with their consequent adverse impact on fuel conservation.

3.202 The intent of the gas guzzler tax was to complement CAFE by discouraging purchases of vehicles with the lowest fuel economies, and thereby encouraging manufacturers to progressively improve the fuel economies of these vehicles. Underlying this objective was the assumption that these vehicles had unnecessarily low fuel economies: they were unnecessarily heavy, had very large engines and high engine-power to weight ratios, all of which (in contrast to the situation with respect to vehicles in the light truck category) could be reduced without sacrificing the utility of the vehicle.

(b) Made effective in conjunction with restrictions on domestic production or consumption

3.203 The **United States** argued that the gas guzzler tax was a critical component of the US fuel conservation program. It restricted domestic fuel consumption by creating a strong disincentive for manufacturers to produce highly fuel-inefficient autos as well as a strong disincentive for consumers to purchase automobiles that fell far beneath the applicable fuel economy standard. Since the CAFE measures were averaged for the manufacturer's fleet, they still permitted the production of inefficient models. The gas guzzler tax created further incentives for a

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manufacturer to improve the efficiency of the lower end of its fleet, and for consumers to avoid purchasing gas guzzlers. These incentives would be rendered ineffective if not applied to imports as well as domestic models.

3.204 The **European Community** argued that the gas guzzler tax had not been implemented in conjunction with comprehensive US restrictions on domestic consumption of oil or other carbon fuels. Article XX(g) appeared to require that a government directly "restrict" consumption of the natural resource, by, for example, taxing oil or energy, instead of, as here, indirectly seeking to control consumption by manipulating demand for secondary products, like autos. Permitting governments to restrict consumption of a natural resource by manipulating demand for secondary products invited protectionist abuses under the guise of safeguarding the environment, particularly if a government was permitted to regulate some (primarily imported) secondary sources of consumption, but not other (primarily domestic) sources. In contrast, a direct tax on gasoline, oil, or energy consumption would ensure strict trade-neutrality, since it would affect all vehicles in direct proportion to their fuel consumption. In addition, it would have an ongoing effect on consumption, as opposed to a one-time tax at the point of sale or production.

3.205 The **United States** argued that the EC's argument was not based on precedent or language of Article XX(g). There was no support for the proposition that a government must "directly" restrict consumption or production, rather than promote conservation indirectly through "secondary measures". Indeed, this assertion directly contradicted the EC's argument with respect to the application of Article XX(g) to CAFE, that "there were of course non-discriminatory means of limiting demand for carbon fuels, such as ... a tax on individual vehicles that corresponded to some objective measure of fuel consumption".

3.206 The **European Community** argued that even if the Panel chose to treat a tax on autos as a surrogate measure for restricting oil consumption, the gas guzzler tax still failed to meet Article XX(g) requirements because it was not part of a comprehensive domestic program for controlling sources of consumption of carbon fuels. The Panel in *Canada - Measures affecting exports of unprocessed herring and salmon* determined that an Article XX(g) restriction had to correspond to domestic conservation measures. In this case, Canada's salmon conservation program covered both salmon species to which export restrictions applied, as well as other species to which there were no restrictions. The Panel concluded that "the export prohibition does not limit access to salmon and herring supplies in general, but only to certain salmon and herring supplies in unprocessed form".[90] Accordingly, a contracting party could not selectively limit trade in certain products while exempting key domestic sources of production or consumption. This would infer that a measure was not primarily aimed at implementing a production or consumption restriction. Therefore, the United States would have to show that the gas guzzler tax was part of a comprehensive set of US restrictions on secondary sources of oil consumption in order to claim an exception under Article XX(g). (The relevant natural resource should not be deemed to be gasoline alone, since gasoline was one of many manufactured derivatives of natural carbon fuel. But even if the relevant natural resource was gasoline, the United States had not taken comprehensive steps to reduce all types of gasoline consumption).

3.207 The gas guzzler tax failed this criterion. It was limited to automobiles and excluded key sources of US oil consumption, such as home heating furnaces, large transport trucks, oil-fired power plants, ships, airplanes, etc. With respect to cars, the United States had applied the tax narrowly to a selected portion of American auto consumption consisting almost exclusively of imports. From the standpoint of energy conservation, it made little sense to penalize only vehicles with fuel economies below 22.5 mpg, since this excluded most American auto sales and thus could

[90] *Id* at para. 4.7.

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have little effect on aggregate consumption of oil. A credible fuel conservation program would require a higher tax threshold that affected sales of mid-sized and even compact vehicles, since these vehicles accounted for most American auto sales and most US gasoline consumption. Thus, the tax was selectively applied in ways that undermined any real impact on domestic energy consumption.

3.208 The selectivity of the tax was also reflected in the exemption of sports-utility vehicles, "mini-vans", pickup trucks, and other light trucks, which constituted more than one-third of total US vehicles sales. Many sports-utility vehicles had fuel consumption ratings that resembled closely those of large passenger automobiles imported from Europe that were currently subject to the tax. If the purpose was in fact to discourage excessive fuel consumption, there was no reason to exempt a whole class of fuel-intensive vehicles from the tax penalty, when these vehicles accounted for a major share of US automotive fuel consumption, and also generally fell below the 22.5 mpg threshold. This aspect of the tax also represented a disguised restriction on trade because the sports-utility market was dominated by American manufacturers and the effect of the exemption was to protect production of the Big Three.

3.209 EPA's regulations permitted the averaging of vehicle configurations with high fuel consumption within a "model type". This loophole enabled domestic manufacturers of like "gas guzzling" vehicles to escape the tax. Accordingly, even if the Panel chose to evaluate the legitimacy of the gas guzzler tax in terms of its impact on domestic consumption of passenger cars falling below the 22.5 mpg threshold, the tax still could not be deemed to have been made effective in conjunction with restrictions on domestic consumption of vehicles with fuel economies below 22.5 mpg. The selective application of the gas guzzler tax showed that the measure was not primarily aimed at conserving energy. Instead, it was a revenue measure that had been structured so that the burden fell on the trade of another contracting party.

3.210 The **United States** argued that it was not required to show that the gas guzzler tax was part of a comprehensive set of US restrictions on secondary sources of oil consumption in order to claim an exception from GATT under Article XX(g). The EC misread the Report of the Panel on *Canada - Measures affecting exports of unprocessed herring and salmon*, and its attempt to draw an analogy simply proved that the gas guzzler tax met Article XX(g) requirements. This Panel could not accept that the measures at issue were primarily aimed at the conservation of salmon and herring stocks since no similar measures were applied to restrict the supply of salmon and herring to domestic processors. The Panel had looked to the practice with respect to other fish stocks Canada had sought to conserve as one of a number of factors in reaching its determination with respect to the intent of the measures. There was no separate requirement under Article XX(g) that all fish be conserved. Canada had imposed restraints on exports of a raw material, but not on the supplies to domestic processors or consumers, and had two different conservation programs applying to domestic and imported fish respectively. No such differential treatment was provided here. All automobiles, foreign and domestic, were subject to the same criteria. Since the gas guzzler tax met the "primarily aimed at" condition, it was within the scope of Article XX(g).

3.211 Further, neither Article III nor Article XX(g) required a contracting party, when it adopted an environmental measure, to take all measures within its power to achieve that purpose. A party was generally not free to take environmental steps with respect to imports only, while exempting domestic production. However, when it restricted domestic production or consumption, it might also ensure that imports did not undercut those conservation measures. In the case of minivans and sports-utility vehicles, imports were free to compete in that sector, and had already begun to do so. (When the tax was first adopted, the only manufacturer of what was recognized as minivans was Volkswagen). The fact that the tax had not been imposed on

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minivans and sport-utility vehicles did not take away from the conservation purpose of the measure.

(c) Arbitrary or unjustifiable discrimination between countries where the same conditions prevail

3.212 The **European Community** argued that the tax constituted arbitrary and unjustified discrimination, as it had been applied almost exclusively to European vehicles on the basis of a criterion (22.5 mpg) which had no rational basis in tax or energy policy. The tax had been targeted at a market segment composed almost exclusively of imported European vehicles. Imported cars from Mexico, Brazil, Korea and Yugoslavia were exempt. This reflected the fact that most other imported vehicles fell in fuel economy ranges that could not be readily segregated from US-produced vehicles. In contrast, European vehicles, which were classified by EPA in lower fuel economy ranges and did not benefit from the averaging scheme, could be readily singled out. While the discriminatory nature of the tax reflected in part the success of European producers in selling large vehicles with limited fuel economy in the United States, it also reflected the effect of carving out, for a punitive tax, a group consisting almost exclusively of imported vehicles. Because Japanese and Swedish vehicles, for example, had fuel economies that were similar to those of US vehicles, they could not be similarly targeted without also taxing the Big Three.

3.213 Given the disproportionate impact of the 22.5 mpg threshold on imported European cars, the United States, as the party invoking Article XX(g), had the burden of showing that the threshold was not arbitrary. The United States should be required to demonstrate, through scientific evidence, why the threshold was set at 22.5 mpg, as opposed to some other figure. In particular, the Panel should examine whether a higher fuel economy would better serve US energy conservation goals, while ensuring non-discriminatory application. If the United States failed to meet this burden, the Panel should infer that the threshold was set for trade reasons, as opposed to legitimate conservation goals, and thus was not exempt from GATT disciplines under Article XX(g).

3.214 The **United States** argued that the gas guzzler tax applied to all gas guzzling models with fuel efficiency averages below 22.5 mpg. It did not apply to automobiles from such countries as Sweden, Japan, Yugoslavia, Mexico, Brazil and Korea (as well as most cars from the EC) because these autos met the transparent, objective standard for gas guzzlers. The gas guzzler thresholds were announced by statute fifteen years ago and, therefore, manufacturers, foreign and domestic, had had more than sufficient notice that a tax would apply to any of their vehicles that failed to meet the specified standard. Indeed, based on projected sales over 99 per cent of imports now met the standard.

3.215 The EC suggestion that the United States would design a program that discriminated in favour of such other countries ascribed too much importance to EC automobile exports by certain manufacturers. Moreover, the EC offered no rationale for why the United States would design a law that favoured goods of these other countries (and some other European exports) over these particular European goods. The tax, imposed on a graduated basis to autos falling below 22.5 mpg, provided an incentive for manufacturers to improve fuel efficiency even incrementally. The threshold was not unreasonable, and was introduced in stages to permit manufacturers, in the United States and overseas, to conform to its requirements. Manufacturers that considered the market benefits of selling gas guzzlers to outweigh the costs of the tax did so, in circumvention of US policy.

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3.216 The EC claim that the United States should have to show "scientific basis" for the threshold was not based on any precedent or language in Article XX(g). Each contracting party was free to determine the level of conservation it desired; this choice was not within the province of GATT. It was not clear how science could enter into such a determination. On the EC claim that the Panel should examine whether a higher threshold for the tax would better serve US energy conservation goals, the US Government, not a GATT panel, was tasked with determining how best to serve US energy conservation goals.

(d) Disguised restriction on trade

3.217 The **European Community** argued that the tax was a disguised restriction on trade. Although it was presented as a neutral tax, in reality it primarily restricted trade in European cars. As had already been demonstrated above, the tax had been targeted at a market segment largely dominated by imported European vehicles and therefore operated as a restriction on trade, robbing European car manufacturers of competitive opportunities guaranteed to them by the US consolidated tariff for passenger vehicles. Further, the tax was structured, through the 22.5 mpg threshold, to exempt domestic automobiles with like or similar fuel economy from taxation. Also, the model-type averaging masked the non-compliance of numerous US-built autos by protecting sales of like vehicles by the Big Three. As the United States admitted, such averaging was a matter of administrative convenience, and was not dictated by energy conservation.

3.218 The **United States** argued that the gas guzzler tax was primarily aimed at conserving fuel. It was a transparent, trade-neutral measure and did not have a protectionist purpose. When the gas guzzler tax was first enacted, 75 per cent of domestic passenger vehicles were below the 22.5 mpg threshold, and European vehicles were expected to meet the thresholds with relative ease. The program's success in conserving fuel was demonstrated by the increased fuel-efficiency of the least fuel-efficient autos in the US market. There was no support for the EC theory that a trade-neutral tax could be considered a disguised restriction on international trade if in practice more of the products of some foreign manufacturers were subject to the tax than the products of domestic manufacturers. The EC attempted to portray the General Agreement as requiring equal impact on all manufacturers; this approach should be rejected.

3.219 Further, the tax achieved legitimate conservation and environmental goals and was not aimed at restricting international trade. It imposed a tax on all automobiles that had less than a specified level of fuel economy to encourage manufacturers to produce more fuel-efficient vehicles, to deter people from purchasing gas guzzlers, and to require that those who insisted on purchasing gas guzzlers paid the resource and environmental costs of their use.

C. Corporate Average Fuel Economy Regulation

(i) Article III:2

3.220 The **European Community** argued that the CAFE program discriminated against imported vehicles in violation of Article III:2 which prohibited a contracting party from imposing taxes or other charges on products in excess of those applied to like domestic products. Since the inception of the CAFE, imported European goods have been forced to bear nearly the entire burden of the CAFE tax, while not one vehicle produced by the Big Three American car manufacturers had ever been burdened by it. From 1980 to 1992, nearly $263 million in CAFE penalties was imposed of which 99.99 per cent was paid on European cars.

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3.221 The fundamental purpose of Article III:2 was to ensure "effective equality of opportunity for imported products".[91] While the 27.5 mpg standard was facially neutral, CAFE's averaging methodology was inherently discriminatory and disproportionately burdened limited-line European manufacturers who did not produce (and had never produced) small cars with high fuel economy to offset the relatively low fuel economy of their high-performance vehicles. Such discrimination was prohibited under Article III:2

3.222 With respect to Article III in general, the **United States** argued that CAFE requirements applied equally to domestic and foreign manufacturers. The penalties for non-compliance with these requirements applied equally to importers and domestic companies, and those paid by certain European exporters were entirely attributable to their own business decisions not to improve the overall fuel economy of their fleets. Article III did not extend protection to particular exporters from the effects of noncompliance with domestic industrial requirements. With respect to Article III:2 specifically, as described in the luxury tax section, the United States did not agree that a case could be established under Article III on the basis of a so-called "disproportionate impact." Moreover CAFE penalties did not even constitute a "tax or other internal charge … applied, directly or indirectly" to a product, as required by Article III:2. While the term "indirectly" broadened the scope to include charges such as a processing tax on a product, the CAFE penalties were neither a tax nor were they charges applied to a product as such. They were civil penalties imposed on manufacturers for unlawful conduct, i.e., the failure to comply with the requirements of a US law of general application that each manufacturer produce a fleet whose average fuel economy equalled or exceeded the requirement. Unlike taxes, civil penalties were not deductible nor shown on a corporate income tax statement, as were the gas guzzler and luxury taxes. Unlike charges on a product, CAFE penalties were not assessed against particular vehicles or against consumers who purchased the vehicles. In these respects, the penalty differed from the anticircumvention duties at issue in *EEC - Regulation on imports of parts and components*[92] or the levies on products purchased by public bodies in *Belgian family allowances*.[93]

3.223 While some manufacturers that had paid civil penalties may have factored the amounts of those penalties into their prices, there was no requirement to do so. A manufacturer could decide to absorb the cost of the penalty temporarily or permanently. If a manufacturer chose to pass the penalty on to consumers in the form of price increases, it was not subject to any requirement that the price increases be allocated in any particular fashion. In fact, in most cases, the notification letter regarding the penalties owed was not even sent to the manufacturer or importer until at least one year after the end of the model year in which there was a violation.

3.224 The **European Community** argued that the penalty was based on a precise count of cars sold or imported into the United States. If this was not to be regarded as a tax on a product, other contracting parties might be encouraged to turn taxes on products into end of year penalty payments, based on a precise count of products sold during a year. The Panel should not accept such a potentially enormous gap in the national treatment principle of Article III. CAFE represented unequal treatment for tax purposes of imported products compared to domestic "like " products.

3.225 The **United States** noted that civil penalties for violations of product standards and other violations were typically based on the number of violations and their severity. The overall increased harm presented by a noncomplying group of products could not typically be precisely calculated; it would have to be roughly estimated. CAFE was different in that the harm flowing

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[91] *United States - Section 337 of the Tariff Act of 1930*, BISD 36S/345, para. 5.11.

[92] Panel report adopted on 16 May 1990, BISD 37S/132, paras. 5.1, 5.9.

[93] Panel report adopted on 7 November 1952, BISD 1S/59, para 2.

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from noncompliance, measured in terms of increased gasoline consumption, could be reliably and precisely quantified. There was no reason why the possibility for greater precision regarding CAFE violations should render the CAFE penalties a "tax". Also, CAFE penalties were assessed on a manufacturer's average fuel economy, not on individual vehicles. It was the manufacturer's overall conduct in failing to comply with a CAFE standard that constituted unlawful conduct subject to a civil penalty, not the manufacture of any particular vehicle. Moreover, the possibility of entering into compliance plans, or using carry-forward "credits", enabled a manufacturer to avoid penalties for a shortfall in its CAFE for a given model year.

(ii) Article III:4

(a) Treatment no less favourable than that accorded to like products of national origin in respect of all laws, regulations and requirements …

3.226 The **European Community** argued that the effect of CAFE was to collectively penalize European cars, while imposing no penalty on like domestic vehicles with the same or worse mileage.[94] Aggregate CAFE statistics showed that European manufacturers had borne nearly the entire burden of CAFE. Since 1983, nearly $263 million had been paid in CAFE penalties; 99.99 per cent of that was paid on European goods. The Luckey study showed that of the fifteen firms that produced vehicles on which CAFE fines were paid since 1980, eleven were European, one was American (Vector Aeromotive), and three were US specialty car firms that altered or re-built existing vehicles by customizing engines or converting engines from gasoline to ethanol. All told, these four US firms had paid a paltry $316,685 of the $263 million in CAFE fines to-date.

3.227 In 1991, vehicles produced by BMW, Fiat, Mercedes-Benz, Peugeot, Porsche, and Volvo generated nearly $40 million in CAFE fines. During that same year numerous Big Three vehicles had individual model type fuel economy values below the 27.5 mpg threshold, yet the Big Three paid no CAFE fines in 1991. In 1990 $48.4 million was paid in CAFE penalties on European goods and again, the Big Three paid no CAFE penalties. Indeed, this degree of disparity had continued since the inception of the CAFE program; the Luckey study showed that in 1989, all but $294,500 of $47,380,515 was paid on European goods. This disparity was the direct consequence of the EPA methodology that set standards that European firms did not have a fair opportunity to meet. The discriminatory and disproportionate impact of CAFE on European vehicles violated Article III:4 and had seriously distorted automobile trade.

3.228 The discriminatory effects were not mitigated by the claimed environmental benefits of CAFE. The EC imposed high taxes on gasoline and carbon fuels consumption; however, the EC believed that environmental measures had to be implemented by contracting parties in a manner consistent with GATT obligations. Moreover, there were trade-neutral and non-discriminatory methods to control the consumption of gasoline, as, for example, through a gas tax or a system of taxing all vehicles according to fuel consumption so that like vehicles were treated alike. The CAFE regulations provided no such trade-neutral environmental benefits.

3.229 The **United States** noted that the EC's complaint was based on the complaints of a few manufacturers regarding the current state of the market and not on the treatment of imports as such, and that arguments under Article III:4 were unfounded. CAFE was a system of requirements placed on manufacturers in order to promote the long-term goal of energy conservation. It was designed to be "technology-forcing", or to compel manufacturers to increase

[94]See National Highway Traffic Safety Administration, Automotive Fuel Economy Program, Report to Congress, 58 Fed. Reg. 6837 (1993).

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the fuel efficiency of automobiles marketed in the United States, while still producing a diverse fleet meeting consumer needs and preferences. It established performance requirements but did not prohibit the manufacture or import of individual automobiles that failed to meet its requirements; nor did it asses a penalty for every automobile failing to meet the average fuel economy requirement. Rather, in order to maximize manufacturer flexibility and consumer choice, it permitted manufacturers to produce vehicles with fuel economy below the level required by assessing compliance based on the average fuel economy of each manufacturer's entire fleet.

3.230 Since the CAFE imposed equal obligations on all manufacturers, the EC's focus on the pattern of civil penalty liability that certain manufacturers had chosen to bear was irrelevant. GATT guaranteed equal treatment but did not protect particular exporters from the effects of noncompliance with national industrial requirements. The CAFE law provided the same choice to foreign and domestic manufacturers: to reduce the proportion of fuel-inefficient vehicles they supplied to the US market or pay penalties. In fact, importers as whole had exceeded both CAFE requirements and the average CAFE of domestic manufacturers in every year since the program had been in force; only certain manufacturers from one contracting party had refused to comply with the requirements in recent years.

3.231 The United States could not accept the EC's argument that imports faced less favourable opportunities in almost every case that a measure had some "disproportionate impact" on certain imports from one contracting party. A disproportionate impact on imports was as likely, if not more likely, to result from the varying conduct or unrelated uncompetitive position of individual companies than from protectionist design. This was surely the case when the "disproportionate" impact did not occur until many years after the enactment of the measure, and was not even alleged to apply with respect to imports as a whole. The EC's "disproportionate impact" theory also ignored the compliance costs that US manufacturers had borne in order to comply with the CAFE requirements; the $265 million in civil penalties paid by some European manufacturers was minuscule compared to the costs of other auto manufacturers in complying with the law by designing, engineering, tooling and producing fuel-efficient automobiles for the US market. If there was discrimination, it was against US manufacturers in that, at the time of the law's passage, they had had to improve their fuel economy by the greatest amount and therefore had had to absorb the greatest cost burden.

3.232 During the first decade of CAFE requirements, manufacturers in the United States had reduced average automobile weight by 1,000 pounds, had reduced average engine displacement, had increased the use of front-wheel drive from 7 per cent to 64 per cent, had increased the use of fuel injection engines from 5 per cent to 54 per cent, and had made other design changes to increase fuel efficiency.[95] In a letter to US transportation authorities dated August 11, 1988, Ford stated that it had spent $12 billion on CAFE improvement actions from model years 1978 to 1986, planned to spend $3 billion dollars on fuel economy programs for model years 1987 through 1989, and $11 billion for the period 1990 through 1995. In addition, Chrysler had invested an estimated $1.3 billion in its new Neon subcompact and Ford was investing an estimated $5 billion in its new Ford Contour/Mercury Mystique compact sedans. The EC had not even attempted to show that the comparatively modest penalties paid by some European manufacturers had resulted from an inability to devise a feasible strategy to comply with CAFE requirements. These penalties were the result of conscious business decisions.

3.233 The fact that some European manufacturers bore a greater penalty burden because of the nature of the vehicles they chose to supply to the United States in no way established or even suggested that imports were treated less favourably than domestic production; it only reflected the

[95] 51 Fed. Reg. 35,603 (October 8, 1986).

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fact that many of the automobiles currently being imported from Europe were relatively fuel-inefficient. European manufacturers were neither penalized for being importers nor for being limited-line producers, rather, for choosing to import fleets consisting predominantly of relatively fuel-inefficient models. This was a legitimate basis for a policy distinction. As stated by another GATT panel, "the Article III:4 requirement was one addressed to relative competitive opportunities created by the government in the market, not the actual choices made by enterprises in that market".[96] The CAFE program was not applied to protect domestic production; whether to comply with CAFE's requirements was a choice made by individual "enterprises in the market" and they were affected accordingly.

3.234 The EC was similarly misguided in hypothesizing about potential alternative approaches the United States could have taken to promote fuel conservation in the automotive sector. Not only was the EC attempting to dictate through a GATT panel proceeding precisely how the United States should achieve its conservation goals, it ignored the limits of these alternative approaches. Even a tax doubling the retail price of gasoline would not be as effective as the CAFE program. Such an increase would only add about $500 to the annual operating cost of a typical passenger car - about a 10 per cent increase in annual operating cost. It would not cause the same dramatic decrease in fuel consumption, or increase in fuel efficiency, as the CAFE program.

3.235 The **European Community** noted that the US automobile market was typical of many international markets in that imports tended to be much more specialized than domestically manufactured products. Even before Congress had enacted CAFE, vehicle manufacturers had developed areas of specialization within the US market. The Big Three fully dominated their target market - mid-size and large vehicles that mainstream American demanded - by offering numerous models for specific segments of that market. For example, Chevrolet, Buick, Oldsmobile, Cadillac, and Pontiac were all GM nameplates. GM achieved economies of scale by placing the same drive train on several different vehicle platforms, many for different model types. Under this system, GM's vehicles had different outward appearances, and often significant variations in fuel economy ratings, but the underlying vehicle was the same.

3.236 Foreign manufacturers, unable to compete with the Big Three in their area of strength, imported vehicles to fill the smaller market segments that the Big Three had largely ignored. Asian manufacturers concentrated on small, inexpensive vehicles, as did a few European manufacturers, most notably Renault and Volkswagen. Japanese manufacturers were unusual in that, after entering the US market as producers of small, fuel-efficient cars during the gas crises of the 1970s, they had since emerged as full-line competitors. Accordingly, they were able to take full advantage of model-type averaging under the gas guzzler tax and the fleet-wide averaging under CAFE. However most European manufacturers focused on the high end of the US market and initially were able to comply by relying on diesel-fuel engines which had high fuel economy characteristics. As a result of this market segmentation, the CAFE program affected different manufacturers in different ways. In fact, the US government had stated that the fleet averaging provisions of CAFE were designed to favour US full-line manufacturers. In a March 23, 1979 letter, National Highway Traffic Safety Administration's Chief Counsel stated, 'we concede that the statutory fleet average compliance scheme, which permits manufacturers to balance low-fuel economy automobiles against fuel efficient ones, is tailored to those manufacturers which have a broad range of product offerings, and that those companies are primarily domestic.'

3.237 The Big Three, which had advocated a CAFE system that would provide manufacturers with "flexibility" in meeting fuel economy requirements, were equipped to utilize the "flexibility"

[96]BISD 39S/206, para. 5.30.

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that averaging provided. In contrast, the European manufacturers had historically focused on the up-scale segment of the US car market, and had much less flexibility. It was more difficult to diversify down-market than up-market. Restructuring down-market required mass production of small cars and, therefore, a more fundamental change in the structure of a company than going up-market into sales of specialty cars, where by definition the number of cars to be produced was much more limited than in producing for the mass market. The United States was, in effect, presupposing either a major industrial restructuring or mergers with US full-line car producers. Under GATT, a contracting party could not impose a tax that would require foreign manufacturers to fundamentally restructure their business in order to escape the penalty of a statute designed to accommodate the domestic manufacturer.

3.238 Like the European limited-line manufacturers, the Big Three also produced cars for the luxury segment with relatively little difference in fuel economy values for those with similar weights. For instance, based on model year 1991 sales and fuel economy statistics, GM's Cadillac division, Ford's Lincoln division, Mercedes-Benz, BMW, and Volvo each had fleet average fuel economy values below the 27.5 mpg CAFE threshold. The US manufacturers each sold more up-market vehicles than all of the European manufacturers combined; however they were able to offset the fuel economy ratings of large vehicles with the fuel economy values of compact and sub-compact car fleets and, therefore, had never had to pay any CAFE penalties.

3.239 The **United States** argued that fleet-wide averaging was not applied to the disadvantage of imported vehicles as such, nor to vehicles of any particular contracting party. The EC's allegation of protectionism was belied by the presence of European and all other foreign manufacturers in the US market not subject to CAFE penalties and by the fact that imports as a whole had exceeded the CAFE requirements and the average domestic CAFE in every year since the beginning of the program. It was obvious that the measure was not applied to protect domestic production when European importers accounted for only 4 per cent of the US market, and one third of these exports had never had any trouble satisfying CAFE requirements.

3.240 The EC's discrimination claim was also belied by past compliance by many of the EC manufacturers that were currently not in compliance. These patterns suggested that certain European manufacturers made a deliberate choice not to comply with the CAFE requirements, even though they had demonstrated early on that they had the capacity to do so. When the National Highway Traffic Safety Administration (NHTSA) was considering reducing CAFE standards in the mid-1980s, non-compliance patterns among several European manufacturers were already in place. While GM and Ford asserted they could comply with lower CAFE standards, European manufacturers, who claimed that they could not meet the 27.5 mpg standard, had no plans to modify their production to try to achieve higher fuel economy levels.[97]

3.241 At the time CAFE was passed, and during much of the time the program had been in effect, there had been no indication that European manufacturers as such could not comply with the program. For example, Alfa-Romeo and Renault participated in the US market through model year 1986 not incurring any penalties. In its last year in the market, Alfa-Romeo had a CAFE of 27.9 mpg and Renault, 33.6 mpg. (Although Alfa-Romeo was still in the US market, it was now part of the Fiat Alfa/Ferrari fleet which currently paid a penalty). Volkswagen, a major EC exporter of fuel efficient automobiles, still participated in the US market and had never incurred any CAFE penalties.

[97]Department of Transportation, NHTSA, *Environmental Assessment for the CAFE Standards for Passenger Automobiles, Model Years 1987-1988*, (January 1986) pg. 3.

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3.242 Other European manufacturers, who had been in compliance for several years, subsequently decided to introduce comparatively low fuel economy models and to pay civil penalties instead. How these particular manufacturers fared under the CAFE program depended not upon where they produced their vehicles, but upon their market choices as to which automobiles to sell in the United States. After CAFE had gone into effect, Mercedes had improved its CAFE to 27.2 mpg by model year 1983, and BMW to 28.0 mpg by model year 1984. Both of these levels were several mpg above those of GM and Ford, and were close to, or above, the long-term 27.5 mpg statutory requirement. Thus, Mercedes and BMW had had only to maintain these CAFE levels to comply with CAFE requirements and avoid civil penalties.

3.243 Instead, during the mid- to late 1980s, European companies like Mercedes and BMW decided to cease their compliance efforts, while domestic manufacturers continued to make substantial efforts. Ford and GM's domestic CAFE performances increased from 24.3 mpg and 24.0 mpg respectively in model year 1983, and to 28.1 mpg and 27.4 mpg by 1993. Meanwhile, Mercedes and BMW both shifted their product offerings up-market toward more high performance, larger, more luxurious, more expensive, and, presumably, more profitable automobiles, without regard to their obligations under US law to comply with CAFE requirements. Thus, three years after achieving a 27.2 mpg CAFE, Mercedes's CAFE had fallen to 21.3 mpg in model year 1986, and four years after achieving a 28 mpg CAFE, BMW's CAFE had dropped to 21.7 mpg in 1988. By 1993, Mercedes' CAFE had dropped to 22.9 mpg and BMW's to 25.2 mpg.

3.244 The United States stressed that European manufacturers, as a whole, had always exceeded the passenger automobile CAFE requirement until model year 1988; for each model year between 1980 and 1985, the average passenger automobile CAFE for European manufacturers had been over 27.5 mpg. However, CAFE levels of European manufacturers as a whole steadily declined after 1984. In contrast, US manufacturers improved their CAFE values over this time in all classes of vehicles, with the average passenger automobile CAFE rising from 24.4 mpg in model year 1983 to 27.4 mpg by model year 1988. US manufacturers continued to invest in new products and technology to improve their fuel economy levels, while some European manufacturers apparently decided it was cheaper to pay the CAFE penalties instead of improving (or even maintaining) the average fuel economy levels of their fleets.

3.245 The EC's suggestion that the average fuel economies of the Lincoln and Cadillac (luxury divisions of Ford and General Motors) should be compared with those of Mercedes and BMW CAFE's was misguided and flawed. Mercedes and BMW were individual companies, and therefore had an incentive each to meet CAFE requirements. In contrast, Cadillac and Lincoln were divisions of larger companies, and did not have an individual incentive to achieve the 27.5 mpg CAFE requirement. Both Mercedes and BMW offered substantial numbers of subcompact and compact vehicles while Lincoln and Cadillac only offered midsize and large passenger automobiles. When comparing like-sized, competitive vehicles, Mercedes and BMW did not reach the fuel economy potential demonstrated by General Motors and Ford. Using data provided to calculate label values for the 1993 model year, the midsize BMW's (the 740i, 740iL and the 750iL) achieved fuel economy from 17 to 21 mpg, while the midsize Cadillacs (Eldorado and Seville) achieved 22 to 23 mpg. The comparison was similar for large automobiles. The Cadillac De Ville and Fleetwood achieved 22 mpg and the Lincoln Continental and Town Car achieved 24 mpg. In contrast, the Mercedes large automobile product offerings equipped with gasoline engines achieved 3 to 7 mpg less (17 mpg for the 500 SEL and 19 mpg for the 400 SEL and 300SE models). Only the Mercedes 300SD (a diesel-powered model) achieved fuel economy higher than the Cadillac and Lincoln offerings. In fact, using information supplied by the manufacturers for 1993 label calculations, BMW and Mercedes tended to achieve the worst fuel economy of all comparable vehicles in their size class; only Rolls-Royce was worse.

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3.246 The following tables were presented to show how, after 1980, European auto manufacturers shifted their product lines toward larger automobiles, larger engines, and more performance, both in absolute terms and relative to US automobile manufacturers.

Change in Average Interior Volume
(cubic feet)

Model year	1980	1992	1992/1980
Euro. Mftrs.	93	106	+ 14%
US Mftrs.	110	113	+ 3%

Change in Average Engine Displacement
(litres)

Model year	1980	1992/1980
Euro. Mftrs.	1.85	+ 50%
US Mftrs.	3.52	-11%

Change in Average Horsepower per Pound

Model year	1980	1992/1980
Euro. Mftrs.	0.0332	+ 53%
US Mftrs.	0.0355	+ 26%

At the first meeting of the Panel, the United States also submitted a graph (Annex 2 of this Report), showing the comparative overall fuel economy by origin from 1975 to 1993. This graph demonstrated the decline in fuel economy of European exports after the mid-1980's, and the overall increase in fuel economy of US and Japanese manufacturers. The graph supported the obvious conclusion that the marketing strategy of many European auto manufacturers towards high performance, fuel-inefficient vehicles, inconsistent with CAFE's purpose, occurred many years after the enactment of CAFE. At the request of the Panel, the United States also provided trade data since 1978. The years 1978 to 1988 showed that total imports of passenger cars increased by 50 per cent, while domestic production declined by 20 per cent. Moreover, over the years, the combined US market share of the particular European exports allegedly aggrieved bore no relation whatsoever to US fuel economy requirements. CAFE could not be said to apply less favourable treatment to imports, inconsistent with Article III:4.

3.247 The EC's claim that imports were inherently discriminated against because importers were limited line manufacturers, ignored the many European and Japanese limited line manufacturers that were producing fuel efficient vehicles at the time CAFE was enacted, as discussed above. Under the CAFE program, importers had several alternatives for compliance; in addition to improving the fuel efficiency of their own cars (the goal of the program), they could purchase imports from another company, or enter into a joint venture with another company to produce such cars. Moreover, as the EC admitted, many Japanese companies (such as Toyota, Nissan and Honda) were full-line manufacturers. Japanese exports to the United States accounted for 65 per cent of all imports, and one fifth of all passenger car sales in the United States. This hardly suggested that being a limited-line manufacturer was an inherent characteristic of an importer. Mercedes' new marketing strategy, announced in early 1993 in European newspapers, also showed that the EC's theory was unfounded in market realities. Mercedes announced plans to respond to a changing and more competitive world market for automobiles by becoming "an exclusive full-line manufacturer offering high quality vehicles in all segments of the market."

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3.248 CAFE's exemption for low volume producers showed the additional flexibility of the program. The exemption for small manufacturers which produced fewer than 10,000 vehicles annually worldwide had served to identify true low volume producers, including, over the years, mostly European producers such as Rolls Royce, Ferrari, Lamborghini and Maserati, that did not have the capability to shift their sales mixes toward more fuel efficient models to meet the CAFE requirements for larger manufacturers. The low-volume manufacturer was relatively limited in its ability to make technological improvements by limited financial resources, small engineering staffs and longer model type redesign cycles. Larger manufacturers such as BMW and Mercedes-Benz had shown, through their historical CAFE levels, that their production and resources were of the magnitude which had enabled them to comply with those generally applicable CAFE requirements.

3.249 The **European Community** argued that the US charge that European carmakers made deliberate business decisions to violate CAFE rested on the graph in Annex 2. This charge was wrong for several reasons and the graph should be adjusted accordingly. European manufacturers had not chosen to import and sell vehicles with lower fuel economy values; the decline in the aggregate fuel economy of European imports was primarily a result of economic forces driving the US auto market, including the disappearance of small European autos due to competition from Japanese imports, and resurgent US demand during the late 1980s for large cars and light trucks.

3.250 During the 1980s, European small car producers virtually vanished from the US market. While Volkswagen started the decade as a leading US seller of small cars, from 1981 to 1992 its US sales volume declined by almost 70 per cent, from 291,002 to 88,515 vehicles. This drop had had a particularly significant effect on the aggregate fuel economy of European imports because Volkswagen was the dominant European importer in 1981 and because Volkswagen vehicles had a relatively high average fuel economy due to the market segment that they targeted. The progress made by European importers in improving fuel efficiency was wiped out by the steep decline in Volkswagen's market share as well as the disappearance of Renault from the US market.

3.251 The decreased viability of diesel-powered vehicles had also had a significant effect on the aggregate fuel economy of European importers. In the early 1980s, European importers led the nation in sales of diesel-powered vehicles whose comparatively high fuel economy values helped the European importers obtain a higher aggregate fuel economy. In 1981 almost 80 per cent of Mercedes-Benz imports contained diesel engines. However, in the mid-1980s, sales of diesel-powered vehicles dropped dramatically. In addition, smaller diesel engines used in Mercedes were barred from the United States, and the smaller gasoline engines of Mercedes and BMW, which met European emission standards, were not capable of meeting US emission standards. BMW and Mercedes estimated that if the smaller engines they sold in Europe that did meet US standards were sold in the United States, their overall CAFE would remain virtually unchanged, demonstrating that Mercedes and BMW were restricted to a limited-line market both in Europe and the United States. Therefore, the end of gasoline shortages, the rise in price of diesel fuel, and more stringent US emissions regulations severely limited European importers' ability to market diesel-powered vehicles in the United States.

3.252 The EC concluded that the decline in the aggregate fuel economy of European imports was based on external forces that had removed large numbers of vehicles with high fuel economy from their aggregate CAFE. Adjusting the US chart to account for these changes would demonstrate that the decline in fuel economy reflected the European market share and a change in sales mix and not individual vehicle fuel efficiency. It would also demonstrate that European importers had improved the fuel efficiency of individual vehicles. Contrary to the US allegations, European manufacturers had devoted substantial resources to improving automobile fuel efficiency. The fuel economy of US manufacturers also improved, although to a lesser extent, when calculated to exclude these changes in market conditions.

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3.253 During the 1980s, EC car manufacturers invested billions of dollars in developing more fuel-efficient models like the Mercedes-Benz 190 class, and in redesigning engines for better fuel efficiency, including developing many of today's leading technologies. EC manufacturers had also pioneered numerous safety-related technologies including widespread use of airbags, anti-lock brakes, and increased structural reinforcement. These innovations were important, as US consumers were placing increasing emphasis on safety features; however, they also added weight to motor vehicles which diminished their fuel economy. Accordingly, the gains by EC vehicles were even more impressive, because they had offset the added weight of the new safety features.

3.254 In addition, the US graph omitted reflecting the 27.5 mpg CAFE standard that would have demonstrated that the US fleet remained below the standard. The graph also omitted light trucks from the Big Three's performance. The rise of the light truck, as described under the discussion of the gas guzzler tax, was one of the most significant developments in the US auto market, and accounted for over one-third of US motor vehicle sales. If light trucks were included in the fuel economy statistics of the domestic and EC manufacturers, the aggregate fuel economy of domestic manufacturers would be below that of European manufacturers. Thus, far from selflessly investing in new fuel economy technology to benefit the global environment and conserve carbon fuel reserves, the Big Three appeared to have shifted production from cars to gas-guzzling minivans and sports-utility vehicles. Thus, any attempt by the United States to portray its domestic manufacturers as environmentally superior to European manufacturers should be disregarded.

3.255 The application of the same CAFE standard for all passenger vehicles - light trucks and passenger cars - would treat all manufacturers equally. The Clinton Administration had considered applying the current standards to light trucks. However, the Administration was "concerned that the move would unfairly affect domestic auto manufacturers, who dominate the light truck market ..." [98] The Administration's view reflected the position of the domestic automobile industry and was incorrect from an international trade standpoint; the current system unfairly favoured domestic manufacturers.

3.256 The **United States** rejected the EC's arguments regarding the "external forces" that required its exporters to market fuel inefficient vehicles to the United States. To the extent these were *market* forces (such as those affecting small cars or spawning the growth of the light truck market), it only underscored the fact that recourse to Article III was not available. A measure could not be discriminatory under Article III if the alleged disproportionate impact on imports resulted from a corporation's failure to react sensibly to a changing market, or a measure's foreseeable impact on a market. By characterizing the market itself as an uncontrollable "external" factor "forcing" a helpless victim company like Mercedes Benz to ignore legislative fuel economy mandates in a major market like the United States, the EC showed that what it considered "equal opportunity" would in fact be a welfare or insurance program for less competitive, or deliberately less compliant, foreign companies. This bore no resemblance to the market principles underlying the General Agreement.

3.257 The EC was incorrect in arguing that the decline in popularity of diesel engines excused the failure of EC manufacturers to meet US fuel economy requirements. US manufacturers had substantially more diesel engine sales volume in 1981 than the combined EC sales of diesel engine vehicles. The US manufacturers' sales decrease in diesel powered passenger by 1985 was also greater than the sales decrease for EC manufacturers. Moreover, BMW, one of the major companies failing to meet CAFE requirements, had never relied on diesel-powered vehicles. Its ability to meet CAFE in early years resulted from a decision to sell light vehicles powered by

[98] *Inside EPA's Clean Air Report* (August 26, 1993), pg. 5.

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relatively efficient 4-cylinder gasoline engines, a market strategy subsequently abandoned. Most importantly, simply because one mechanism for reducing fuel consumption may have been less attractive did not mean other means to reduce fuel consumption could not have been employed. For every carline that Mercedes and BMW imported to the United States, the companies marketed a version with a smaller engine in Germany. The EC's assertion, that US emissions standards prevented EC manufacturers from importing such vehicles, was unsupported. Experience demonstrated that fuel economy and US emissions standards could be met simultaneously.

3.258 The EC's claim that their manufacturers were forced to add safety features to their cars, and hence prevented from complying with fuel economy requirements, was also empty. US manufacturers also had to comply with the same safety standards as EC manufacturers and still complied with CAFE requirements. Although weight and engine displacement reductions were commonly used by the US manufacturers to benefit their CAFE, even comparing vehicles of similar size and weight revealed lack of fuel efficient features in Mercedes and BMW models compared to US and Japanese luxury models. Lincoln and Cadillac models achieved 2 to 5 mpg greater fuel economy than comparable offerings from Mercedes and BMW.

3.259 The improvement in domestic manufacturers' average fuel efficiency was not due to sales shifts to small highly fuel efficient vehicles,but to design improvements to vehicles across the domestic manufacturers' entire product lines. One example was the Ford Lincoln Continental, a luxury car directly in competition with the Mercedes 500 series model. Design changes in the Lincoln Continental beginning after 1978 resulted in a fuel economy improvement from 18 mpg in 1978 to 25.6 mpg by 1988. All these changes were made without decreasing the interior volume or attributes of luxury favoured by consumers. (In fact interior volume increased.) The Mercedes model today was still below the mileage level of the Lincoln Continental in 1978.

3.260 Nor was the ability of domestic manufacturers to comply with CAFE standards for passenger vehicles due to their increased production of light trucks. As discussed in the section below regarding the 27.5 mpg standard itself, even if one included minivans in passenger car fleets, the average CAFE for that group would exceed the current CAFEs of the EC manufacturers at issue. It was clear that the separate light truck CAFE class was not established to protect light trucks from import competition. In model year 1980, light trucks accounted for less than 17 per cent of all vehicles covered by CAFE, and most of these were for commercial use. The best known passenger vehicle was an import, the Volkswagen minibus. In model year 1992, light trucks accounted for over 33 per cent of all light vehicles, and they were used more often to carry passengers. The General Agreement did not support the proposition that a law could be rendered retroactively protectionist because of changing market conditions. As discussed with respect to the gas guzzler tax, there were important technological and economic policy reasons to consider light trucks a separate class of vehicles, reflecting the recognition that compromises in fuel economy might be required to meet the load carrying and occasional off-road uses of such vehicles. Minivans had design characteristics that enabled them to perform personal and commercial tasks that cars could not perform. One was much greater cargo carrying capacity for objects larger than suitcases. Minivans were often used for non-commercial carrying of furniture, large boxes and other objects larger than could be carried in the trunk of a large automobile. Minivans were also frequently used for recreational purposes, such as camping, and were frequently used to tow boats, trailers and other recreational equipment. (Towing capacity was dependent on the ability to carry a heavy load.)

3.261 The fact that many light trucks were ultimately used for passenger carrying purposes was irrelevant, since the distinction between passenger vehicles and light trucks was based not on the actual use of the vehicle, but on the physical characteristics and potential use that determined fuel economy. All light trucks still had to be designed to have the capability to be used for load-

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carrying purposes. Passenger vans had a flat floor, and all seats behind the driver were removable. Typically, passenger vans also had full-width rear doors to facilitate loading of bulky cargo. Automobiles that qualified as light trucks because of their off-road capabilities had four-wheel drive and had to meet certain ground clearance criteria. Moreover, even if the CAFE program did provide an incentive to market such vehicles, the same opportunity was available to importers and domestic manufacturers. To use the EC's expression, the same "external forces" applied to all those who supplied the US market. Indeed, Japanese manufacturers, and Volkswagen and other European manufacturers, had already responded to this trend, and Mercedes had announced plans in early 1993 to develop a sport-utility vehicle for the US market as well. The inability or unwillingness of other European manufacturers to produce competitive light trucks did not make the separate CAFE requirement a "loophole" in the program, as the EC had claimed.

3.262 As a practical matter, and most importantly, the EC's claim that the CAFE program provided less favourable treatment to imports was contradicted by its focus on European imports from specific manufacturers. Japanese manufactures had a substantial compliance margin, not shared by domestic manufacturers, which had relieved them of the necessity of making large investments to achieve compliance. This had enabled them to introduce luxury high performance/low fuel economy automobiles without reducing their CAFE below the requirement. The EC's argument was also undermined by the fact that the average CAFE values for imported passenger automobile manufacturers as a whole (including Asian and European manufacturers) had exceeded both the CAFE requirement and the average domestic CAFE for every model year since the initiation of the program as shown in the table below.

Model Year	**(1)** **Car CAFE Standard**	**(2)** **Avg. Imports CAFE**	**(3)** **Avg. Domestic CAFE**	**Margin (2) - (3)**
1978	18.0	27.3	18.7	8.6
1979	19.0	26.1	19.3	6.8
1980	20.0	29.6	22.6	7.0
1981	22.0	31.5	24.2	7.3
1982	24.0	31.1	25.0	6.1
1983	26.0	32.4	24.4	8.0
1984	27.0	32.0	25.5	6.5
1985	27.5	31.5	26.6	4.9
1986	26.0	31.6	26.9	4.7
1987	26.0	31.2	27.0	4.2
1988	26.0	31.5	27.4	4.1
1989	26.5	30.8	27.2	3.6
1990	27.5	29.8	26.9	2.9
1991	27.5	30.0	27.3	2.7
1992	27.5	29.0	27.0	2.0

3.263 The United States provided the CAFEs of all manufacturers over the years, as well as the yearly requirements, in a table which reflected the extent of individual company decision making involved with respect to CAFE compliance. A large disparity between the CAFE compliance of two manufacturers from the same country, Volkswagen and Mercedes Benz, underscored the non-discriminatory nature of CAFE requirements. If some European manufacturers were not in compliance with the requirements, it was not because the CAFE program discriminated against imports as such.

3.264 The **European Community** argued that analysis of CAFE averages on an aggregate basis ignored the effects of fleet-wide averaging on limited-line manufacturers of luxury vehicles. Such

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manufacturers were primarily European. In fact, if the fuel economies of European and domestic full-size cars with similar weights were compared, there was relatively little difference in fuel economy values. For instance, based on Model Year 1991 sales and fuel economy statistics, the following chart demonstrated that GM's Cadillac division, Ford's Lincoln division, Mercedes-Benz, BMW, and Volvo each had fleet average fuel economy values at comparable levels below the 27.5 mpg CAFE threshold. The two US manufacturers sold more up-market vehicles (without penalty) than all of the European manufacturers combined.

Manufacturer	Model Year '91 Sales	Fuel Economy	Penalty
Cadillac	208,534	22.1	0* ($56,304,180)
Lincoln	180,047	23.1	0* ($39,610,340)
Mercedes-Benz	73,729	22.3	$19,169,540
BMW	52,322	23.2	$11,249,230
Volvo	70,622	25.3	$ 7,768,420

* Despite their low fuel economy values, the Cadillac and Lincoln divisions paid no CAFE penalties. The dollar amounts in parentheses indicate the CAFE penalties these manufacturers would have paid had they not been able to average their fuel economy values with those of other GM and Ford divisions.

3.265 The Big Three were able to offset the fuel economy ratings of their large vehicles with the fuel economy values of their compact and sub-compact car fleets and, therefore, had never had to pay a single dollar in CAFE penalties. European manufacturers were thus forced to develop vehicle lines outside their market segment in the United States - an undertaking which they had determined would be economic suicide - or pay the CAFE penalty. Neither option was acceptable under GATT.

(a)(i) Fleet averaging

3.266 The **European Community** argued that under Article III, a contracting party had to provide equal and non-discriminatory treatment to imported goods in its internal laws and regulations. Rather than tax like products equally, the United States pursued a complex regulatory scheme that, by use of a calculation methodology favourable to domestic firms, impermissibly skewed the competitive conditions between domestic and foreign cars. As for the gas guzzler tax, the model type fuel economy was the basis for determining each manufacturer's or importer's overall fleet average. Because the methodology to determine CAFE compliance was based on the average fuel economy of a manufacturer or importer's total fleet of passenger automobiles sold in the US market, larger vehicles with poor mpg ratings could be sales-averaged with smaller, less fuel-consuming vehicles to reach the 27.5 mpg standard required under CAFE. This was skewed against European, limited-line automobile manufacturers who had almost exclusively incurred the CAFE penalties. The US Congress had considered other tax mechanisms, such as a per-vehicle tax, but rejected them to protect the domestic car industry. The Ways and Means Committee of the U.S House of Representatives stated:

> [The] committee considered heavier taxes on fuel-inefficient automobiles, as well as the possibility of providing tax credits for fuel-efficient cars. It was decided not to impose a heavier tax because of the danger of a major loss of jobs in the automobile and related industries. Currently, many fuel-efficient cars are imported, and your committee did not

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> want the auto efficiency tax to provide a stimulus to increased imports of autos in view of the depressed state of the US auto industry…"[99]

3.267 The **United States** argued that fleet averaging provided all manufacturers, domestic and foreign, with the same flexibility in meeting US energy conservation requirements. Any manufacturer that sold vehicles with fuel economy below the requirement had to sell sufficient vehicles with fuel economy above the requirement to avoid CAFE penalties. As discussed in the context of the gas guzzler tax, the drafting history of the General Agreement clarified that Article III did not prevent contracting parties from regulating their industries, so long as they subjected imports to the same treatment as domestic products.

3.268 The **European Community** considered that this system provided advantages to large, full-line manufacturers that marketed numerous car lines, each containing several model types, because it gave them the flexibility to adjust their product mix so that the overall fleet average achieved 27.5 mpg average. Vehicles with the same inertia weight class, basic engine and transmission class but with different car lines could be placed in the same base level for testing. While vehicles with these common characteristics would have similar fuel economy values, differences in the vehicle configurations within each base level could create significant variations in fuel economy. A large manufacturer could "raise" the fuel economy value for a particular vehicle by ensuring that there were other vehicle configurations and subconfigurations in that base level, or other base levels within the overall model type, with a sufficiently high fuel economy to offset the fuel economy of less efficient vehicles.

3.269 On the contrary, small, limited-line manufacturers (like European manufacturers) did not have this flexibility because each of their model types typically was composed of only one base level, within which there were relatively few vehicle configurations and subconfigurations. Because of the nature of the US market, European producers had to concentrate on a limited line of high-quality cars incorporating advanced technology, styling, and safety features; because they did not also produce or import smaller cars, they were not in a position to engage in effective fleet-wide averaging. Manipulation of the CAFE methodology was especially difficult for limited-line European manufacturers that did not design their vehicles primarily for the US market. Such manufacturers could not afford the expense of designing, building, and marketing cars of particular subconfigurations, configurations, or base levels simply to manipulate the US CAFE regulations.

3.270 If a contracting party was permitted to impose taxes that essentially required importers to sell a full product mix, this rule would have a significant adverse impact on international trade. Importers had traditionally specialized in products that were not available domestically or produced for market segments where domestic industry was less competitive, generally at the high and low ends of the market. Thus, a tax rate or regulation that penalized manufacturers for not selling goods at both ends of the market, or for serving a special niche rather than selling a full line of products, discriminated against imports. For example, a contracting party could design a facially neutral tax that required all sellers of textiles and apparel to market a full product line, ranging from cotton underwear to $750 suits. While trade neutral on its face, it would have a serious discriminatory effect, since specialty importers would be unable to comply. Similarly, a regulation requiring wine makers to sell all varieties of wine, from the cheapest to the most refined, would have only a marginal effect on domestic wine makers that produced at a wide variety of price and quality levels but would destroy importers who were likely to focus primarily on the high-quality segment of the market.

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[99] H.R. Rept. No. 94-221, 94th Congress, 1st Session, p. 14 (1975).

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3.271 Further, there was a difference between fuel economy and fuel efficiency. European high-performance cars typically were very fuel efficient considering their size and performance characteristics, which were a function of consumer demand. By comparison, some compact vehicles had high fuel economy due to their smaller size but actually had inefficient engines. If these vehicles had fuel efficiency comparable to the efficiency of European high-performance vehicles, their fuel economy values would be even higher. Further, the only valid comparison of fuel economy was that among specific car lines in the same market segment. For example, both the 1993 Cadillac Allante and the 1993 Mercedes-Benz 500 SL were expensive two-seaters, were sold in hard top and soft top configurations, had V-8 engines, had similar horsepowers, and met the same emission compliance standards. While the 500 SL weighed almost 1,000 pounds more than the Allante, both vehicles had the same fuel economy.

3.272 Even disregarding the structural disadvantage that CAFE placed on European manufacturers, if CAFE were computed on pickup trucks, minivans and sports-utility vehicles as the passenger-carrying vehicles they were, or if each such vehicle were taxed on its individual fuel efficiency, the average fuel economy levels and their corresponding financial burdens on European imports and domestically produced vehicles would be virtually identical. Despite this, the impact of CAFE was skewed against European importers because they were unable to take advantage of loopholes in the CAFE laws. CAFE penalties were imposed on European vehicles and not on like domestic vehicles with the same or worse fuel economy; this dissimilar treatment violated GATT rules.

3.273 The **United States** argued that the premise for the EC's complaint, that CAFE was discriminatory because EC manufacturers "did not design their vehicles primarily for the US market," was at odds with the underlying principles of the General Agreement. The EC implied that governments had some obligation to adapt their measures to the practices of foreign manufacturers. It was a strange commercial decision to ignore the intended market when designing a product, and would be even stranger for GATT, if Article III were to be interpreted as guaranteeing a particular market segment for certain exporters.

3.274 The EC was proposing that a GATT panel examine whether a contracting party had chosen the most effective option in achieving social policy objectives; the United States understood that it was the province of GATT only to examine whether, in pursuing such objectives, contracting parties had acted in a manner inconsistent with the General Agreement. The EC was also inviting the Panel to interpret Article III in two novel respects, neither of which should be accepted by the Panel. The first was to consider the trade effects of a measure to be relevant in assessing whether equal treatment was provided, and the second was to permit an inference of protectionism to be made, not on the basis of the treatment of imported goods, but on the inconvenience of the measures to some foreign manufacturers.

3.275 The EC's claims mis-characterized CAFE's operation and failed to recognize the limitation of its rights under Article III:4. CAFE requirements were imposed on manufacturers' imported and domestic fleets, not on individual products, and were applied even-handedly to vehicles in those fleets. As such, these were measures relating to manufacturing that were consistent with Article III. In conformity with Article III:4, any domestic automobile belonging to a fleet that conformed with CAFE requirements was provided the same treatment, and subjected to the same averaging methodology, as an imported automobile of a complying fleet. Furthermore, CAFE requirements were not applied so as to afford protection to domestic production. This could be inferred from several facts: European manufacturers were able but chose not to comply with CAFE requirements; the importers incurring penalties were doing so because of the low fuel efficiency of their vehicles, not because the system was designed to target imports; the CAFE law did not disfavour imports as a class (Japanese automobile manufacturers and many others met

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CAFE requirements); and the fleetwide averaging methodology was based on a legitimate policy objective.

3.276 Further, the United States considered that the EC's claims regarding limited-line manufacturers being unable to "manipulate" the US CAFE requirements ignored the point that most European limited-line manufacturers, at the time CAFE was enacted, marketed fuel-efficient vehicles and had an advantage over full-line companies that had had to develop fuel efficiency technology for the entire line. Moreover, GATT did not require that the burdens of compliance with a law be equal among manufacturers, yet the EC was demanding an exemption from US requirements because they were inconvenient and expensive for some of its manufacturers. GATT did not require a contracting party to change a measure years after enactment for particular exporters' convenience.

3.277 Since CAFE requirements specified a minimum fuel economy level that manufacturers had to meet for their fleet as a whole, the EC's suggestion that the lower fuel economy ratings of the European manufacturers were somehow related to "manipulation" of CAFE regulations missed the point. The CAFE law provided manufacturers with flexibility in meeting US energy conservation goals, since they could offset vehicles below the requirement with ones that were above it. There was nothing manipulative in the process. In reality, BMW's and Mercedes' passenger automobile fleets were much less energy-efficient than GM's or Ford's, because the domestic manufacturers had, as a result of their CAFE obligations, produced higher fuel-efficiency vehicles to offset their lower fuel-efficiency ones. The CAFE law permitted the European manufacturers to improve their average fuel economy in a variety of ways, including marketing more fuel-efficient vehicles, entering into a joint venture with another manufacturer to produce more fuel-efficient vehicles or purchasing such vehicles from other foreign manufacturers and selling them in the United States. However, in recent years, most had chosen not to do so. Even comparing 1990 model year offerings of the same size and weight, the vehicles offered by Mercedes and BMW had fuel efficiencies 2 to 5 mpg less than competitive vehicles offered by General Motors and Ford.

3.278 Moreover, using the flexibility permitted by the law to achieve a CAFE above the requirement was not without cost to domestic, Japanese and other manufacturers. If the design differences that resulted in improved fuel economy (e.g. smaller size vehicles or smaller, less powerful engines) represented losses in attributes favoured by consumers, then this ability to "manipulate" product mix to ensure an overall fleet average above 27.5 mpg came at a cost to the manufacturer in terms of lost sales and lost profits.

3.279 The EC's argument that CAFE standards for passenger cars would have to be lowered if minivans were covered, thereby exempting European automobiles from penalties, was speculative and misguided. As discussed in the context of the gas guzzler tax, and in the previous section, there were legitimate technological and policy reasons for distinguishing light trucks from passenger vehicles. Moreover, the average CAFE for the largest US cars was projected at 24.3 mpg for 1993. The average fuel economy for all minivans, sport-utility vehicles and pickups combined was 22.9 mpg, well above the average CAFE for large European cars, which was only 20.8 mpg. If one combined domestic passenger minivans with the domestic passenger car fleet for 1993, the average would be 26.8 mpg, which was less than one mpg below the current CAFE standard. This hardly suggested that a separate CAFE standard for minivans acted as a loophole for domestic manufacturers. In fact, light trucks were not even competitive with the vehicles produced by companies currently paying CAFE penalties. The average price of minivans and sport-utility vehicles was less than $20,000, while the large EC luxury vehicles in question ranged from $25,000 to $120,000. Mercedes and BMW models offered consumers attributes that were significantly different than those offered by light trucks, and targeted different market segments.

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The EC had not presented any serious market studies to suggest that these different market segments were in fact interchangeable.

3.280 Implementation of CAFE requirements could also be seen as having benefitted many of the larger European manufacturers. Domestic manufacturers' decisions to comply with the CAFE requirements had constrained their ability to sell more powerful, less fuel-efficient models. By choosing not to comply in recent years, certain European manufacturers had been able to exploit this segment of the market, while paying only a relatively modest civil penalty that, on a per car basis, was far less than the profit margin of the vehicles. Assuming for argument that all CAFE penalties were passed on proportionately to each vehicle in a fleet, even a 10 mpg shortfall from the CAFE requirement would cost manufacturers no more than $500 per vehicle.

3.281 When the CAFE law was passed, Congressional concerns about raising fuel efficiency requirements in no way suggested an intent to target European imports or specific manufacturers so as to protect domestic production. In 1977, the National Highway Traffic Safety Administration (NHTSA) projected that the vast majority of foreign manufacturers could improve their fuel efficiency levels sufficiently to meet the 27.5 mpg requirement in 1985. Specifically the CAFE levels of Mercedes and BMW manufacturers did not significantly differ from those of the domestic companies. Regardless of the relatively fuel-inefficient cars they marketed in the United States, European auto manufacturers had always produced more fuel-efficient vehicles on average.

3.282 The United States considered that the EC claim that US reliance on fleet-averaging did not advance, and in some respects undermined, the goal of energy conservation since it permitted full-line manufacturers to sell large numbers of autos with high fuel consumption, ignored the fundamental purpose of the CAFE program, which was to ensure long-term changes in the US automobile industry that would lessen fuel consumption in the United States. In establishing the US fuel economy policies, Congress explicitly recognized that these benefits could not be captured by relying on market forces alone, although it wanted to preserve their impact as much as possible. While Congress could have specified a minimum fuel economy requirement for each vehicle, it decided to maximize manufacturer flexibility and consumer choice by permitting manufacturers to produce vehicles with fuel economy below the level of the requirement if they produced sufficient vehicles with fuel economy above. An averaging approach was the most efficient and effective method to reduce overall fuel consumption.

3.283 Averaging gave manufacturers more flexibility in deciding how to change their product line to meet the requirements and where fuel economy could be improved most cost-effectively. Aggregate averaging also enabled manufacturers to continue to provide consumers with a variety of types and sizes of vehicles; it permitted government authorities to regulate without eliminating any interior size class of vehicles and without telling manufacturers how much to improve any particular weight class; and enabled regulatory authorities to influence not only the fuel economy of different weight classes of vehicles, but also the distribution of vehicles among the size classes. Under average fuel economy requirements, manufacturers achieved compliance both by improving the fuel economy of their various classes of vehicles and by increasing the proportion of vehicles in the lighter weight classes. If the CAFE statute authorized different requirements for different weight classes of vehicles, the authorities could not influence mix, and thereby prevent achievement of the fuel conservation goal under CAFE.

3.284 Presumably, the EC would not object to setting different fuel economy requirements for different size classes of vehicles. However, this approach would make it more difficult to ensure that the specific policy objective - achieving a certain level of fleetwide fuel economy - could be met. Manufacturers would no longer have a disincentive against concentrating their product line in the generally more profitable luxury or high performance models which had lower standards of

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efficiency. Manufacturers could decide to produce only those vehicles falling into the least fuel-efficient class, resulting in a fleet with significantly lower CAFE. Further, this approach would require that the requirements applied to each vehicle class be continually adjusted to reflect current product lines; this might be impractical given the industry's need for adequate lead time to meet a given requirement. Moreover, without control over mix, an overall level of fuel economy could not be ensured. Finally, requirements based on size, performance or some other model-specific parameter would be considerably more susceptible to gaming by industry. Manufacturers could escape the stringent requirements for the lighter weight classes by increasing vehicle weight just enough to move them into the next heavier weight class.

3.285 Fleet averaging in CAFE was a reasonable means to accomplish the goal of raising the fuel efficiency of autos sold in America. (In fact, Germany had also adopted corporate average fuel economy goals enforced through voluntary commitments from both domestic companies and importers.) US domestic manufacturers had not paid penalties for their vehicles below the 27.5 mpg requirement because, in accordance with the law's intent, they had marketed sufficient vehicles above the requirement. The choice by certain European companies not to comply with these flexible requirements did not undermine the intent of the law nor the reasonable nature of its methodology. Fleet-wide averaging was not applied to disadvantage imported vehicles as such and could have disadvantages for full-line manufacturers which might have to reduce or eliminate profit margins on small automobiles in order to sell enough of them to meet CAFE requirements for the fleet.

3.286 The **European Community** agreed that averaging was a perfectly acceptable choice for regulators to utilize when assessing taxes or imposing penalties, but it had to be employed in a manner that was truly objective and trade-neutral. It was not sufficient to say that an averaging methodology was GATT consistent because exports and imports and domestic vehicles were "subject to the same averaging methodology" when that methodology had a substantially disproportionate effect on imports, and when US energy conservation objectives could be readily achieved through other regulatory approaches. Averaging should not, by intent or effect, deny equality of competitive opportunity to imported products. Because the CAFE averaging methodology was designed to, and had the effect of, disproportionately burdening European imports, it failed this test of fairness.

3.287 The **United States** disagreed with the EC's assertions in every respect. In terms of Article III:4, the CAFE requirements provided imports and domestic automobiles equal competitive opportunities in the US market. There was no discriminatory intent or effect, as imports had exceeded the CAFE standards and the average domestic CAFE during every year since CAFE had been effect. To base a claim under Article III on the complaints of a few manufacturers would make the consistency of a contracting party's measure dependent on the business decisions of foreign corporations. This was inconsistent with all GATT precedent. As stated by a previous panel, "the Article III:4 requirement was one addressed to relative competitive opportunities created by the government in the market, not the actual choices made by enterprises in that market."[100] The assessment of penalties to certain EC companies was entirely avoidable. European imports were not less fuel-inefficient than domestic vehicles when CAFE was enacted, but during the mid 1980s, after complying with CAFE for many years, Mercedes and BMW both shifted their product offerings upmarket toward more high performance, larger, luxurious, expensive and presumably more profitable automobiles, without regard to their obligations under US law to comply with CAFE requirements. Even today, neither of these manufacturers offered so basic a fuel-economy enhancing technology as front-wheel drive. The decision by the EC manufacturers to simply move up-market and not improve fuel economy

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[100]Report of the Panel on *United States - Measures affecting alcoholic and malt beverages*, BISD 39S/206, para. 5.30.

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reflected their management, including the deliberate pursuit of relatively higher profit margins - not discrimination on the part of a US Congress primarily concerned with energy conservation on a national scale.

(b) Separate foreign fleet accounting

3.288 The **European Community** noted that under CAFE, a manufacturer could not average together the mpg ratings of its imported and domestic cars.[101] Rather, each manufacturer's passenger car product line was divided into separate "foreign" and "domestic" fleets, each "treated as if manufactured by a separate manufacturer" and had to comply separately with the 27.5 mpg standard. For purposes of CAFE, EPA had defined a "foreign" car as any vehicle of which less than 75 per cent of the value came from the United States or Canada.[102] The legislative history of the CAFE law made clear that the "two-fleet" distinction was added at the behest of the United Auto Workers union, which represented employees of the auto industry. The union was concerned that the effort to promote increased fuel economy through CAFE would lead the Big Three to import small cars in order to achieve US fuel economy goals; Congress added the two-fleet rule, also referred to as the "runaway plant amendment", in order to prevent this and keep small car production in the United States. The US industry had traditionally concentrated on production of larger cars, which were more profitable. Accordingly, demand for small, fuel-efficient models was being supplied by Volkswagen and the Japanese manufacturers. The effect of the two-fleet rule was to create an incentive for the Big Three to manufacture small cars in the United States, since this was the only way to gain sufficient small car credits to offset domestic production of large, fuel-consuming automobiles.

3.289 Given that the CAFE program was implemented in order to promote increased fuel efficiency, a legitimate environmental purpose, it was not apparent why the US energy conservation and environmental protection policies included discouraging the importation of small, fuel-efficient cars through the two-fleet rule. The sale of fuel-efficient cars, regardless of origin, would have positive benefits for the environment, conservation of global reserves of carbon fuels, and protection of the global commons. Therefore, the two-fleet rule was odd, as its motives seemed trade-oriented and protectionist. Indeed, in a comprehensive report on the CAFE program, which was commissioned by the US National Highway Traffic Safety Administration, the National Research Council stated: "It is the committee's view that the domestic-content provision has no obvious or necessary connection to the achievement of fuel economy ... Consideration should be given to the elimination of this provision".[103]

3.290 The separate fleet accounting provision violated the principles of Article III by affording protection to US production of small, high-mileage automobiles. Absent CAFE, US manufacturers could import compact and sub-compact vehicles from Europe to fill out their product lines. Because the Big Three had extensive production operations in Europe, and manufactured highly competitive small cars there for the European market, this approach would make economic sense. CAFE, however, forced the Big Three to locate small car production in the United States or Canada, so that any CAFE credits generated could be used to offset their North American production of large vehicles. It was unclear how the Big Three might react if the local content provisions were stripped from CAFE. Nevertheless, as the Panel on *United States - Section 337* noted, the "previous practice of the Contracting Parties has been to base their

[101] 15 U.S.C.§2003(b)(1).

[102] *Id* at §2003 (b) (2)(E); 40 C.F.R. 600.511-80. The EC added that since the 1965 US-Canada Auto Pact, the Big Three had essentially integrated their US and Canadian operations. Thus, US law treated Canadian auto production as US for most regulatory and tax purposes.

[103] *Automotive Fuel Economy*, pg 184.

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decisions on the distinctions made by the laws, regulations or requirements themselves and on their potential impact, rather than on the actual consequences for specific imported products."[104]

3.291 CAFE also had the perverse effect of sometimes discouraging production of large, high-mileage vehicles with high US content. For example, many Japanese manufacturers with US production operations strove to keep the North American content of their vehicles below 75 per cent. These vehicles had fuel economy ratings below 27.5 mpg and would otherwise be subject to CAFE penalties if treated as a separate domestic fleet. By keeping such vehicles in the import category, the Japanese manufacturers could offset these vehicles with small, less fuel-consuming imports. Similarly, the Big Three had sometimes shifted large, low-mileage models into their import fleets. Ford reduced the US content of the Crown Victoria, one of the lowest-rated cars on fuel economy, to below 75 per cent in order to shift it into Ford's import fleet. Because Ford imported numerous small, high-mileage vehicles from Mexico (e.g. Mercury Tracer) and the Far East (Ford Festiva), it was able to balance the Crown Victoria against the fuel economy ratings of other imported vehicles.

3.292 For purposes of this proceeding, however, the United States could not argue that the protectionist effects of CAFE on imported small passenger cars were offset by its effect of increasing trade in large cars. The Panel on *United States - Section 337* "rejected any notion of balancing more favourable treatment of some imported products against less favourable treatment of other imported products … this … would entitle a contracting party to derogate from the no less favourable treatment obligation in one case … on the ground that it accords more favourable treatment in some other case, or to another contracting party. Such an interpretation would lead to great uncertainty about conditions of competition between imported and domestic products and thus defeat the purposes of Article III."[105]

3.293 The Panel on *Canada - Administration of the Foreign Investment Review Act* had considered Canada's practice of seeking written undertakings from potential foreign investors which included commitments to purchase goods or services from Canadian suppliers. The Panel had found that Article III:4 prohibited any contracting party from using internal regulations to discourage the purchase of imported products.[106]

3.294 Also, the Panel on *European Economic Community - Regulation of imports of parts and components*, in addressing a policy of accepting undertakings to purchase domestic parts to resolve investigations of possible circumvention of antidumping measures under Article VI, found that "comprehensive coverage of all laws, regulations, or requirements affecting the internal sale, etc., of imported products suggested that not only requirements which an enterprise was legally bound to carry out … but also those which an enterprise voluntarily accepted in order to obtain an advantage from the government constituted requirements within the meaning of the provision [of Article III:4]."[107] The "two-fleet" rule plainly "affects" the internal sale of imported small cars within the meaning of Article III:4 by creating an incentive to produce domestically that otherwise would not exist.

3.295 The **United States** argued that the separate fleet accounting requirement did not treat imported automobiles less favourably than domestically produced automobiles. Once designated as belonging in a domestic or imported fleet, there was no intrinsic advantage to belonging to one or another as the standard, data requirements, and calculations were the same. Indeed, many of

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[104]BISD 36S/345, para. 5.13.

[105]*Id* at para. 5.13.

[106]Panel report adopted on 25 July 1983, BISD, 30S/140, para. 5.9.

[107]Panel report adopted on 16 May 1990, BISD 37S/197, para. 5.21.

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the vehicles classified as belonging to an import fleet were in fact produced domestically and were a domestic product in GATT terms. Thus, while the continuing rationale for the two-fleet policy may be questionable in a context where auto production was increasingly internationalized, and where the rules were producing, as the EC stated, "perverse" results, erasing the distinction between domestic and imported fleets would not provide more favourable treatment for European imports. Eliminating separate accounting requirements would give those American and Japanese manufactures that did produce autos both in the United States and overseas more flexibility and would allow them to satisfy CAFE requirements with greater ease.

3.296 The EC claim, that if it were not for CAFE more fuel efficient autos would have been imported from Europe, ignored both the EC's own implicit admission that European small cars had been unsuccessful in competing against Japanese small cars in the US market, and that CAFE was aimed at improving the fuel efficiency of the entire line of US auto production, not just at producing small cars. The EC had also failed to show that it would have been able to compete but for the separate fleet requirement. It had not shown that any alleged decrease in EC exports was not due to the declining competitiveness of the EC industry.

3.297 The separate fleet accounting requirement provided an incentive to import high performance, fuel-inefficient cars, since the Big Three's European imports were well above the CAFE standard. GM imported Maseratis, Lotuses, Saabs and Aston Martins. Ford imported Jaguars. Ford also imported Merkur high performance cars from its European subsidiary. The EC's argument assumed that Article III:4 required that a measure not only treat imports and domestic products equally, but also guarantee imports a future share of all segments of the domestic market. Such a theory was not based on the General Agreement and ran against its free market principles. While Article III prohibited discrimination against imported products, it did not impose an obligation on contracting parties to select among their policy choices the option that maximized incentives for imports. The two-fleet rule ensured neutrality: CAFE requirements had to be met separately for domestic and import fleets.

3.298 Far from benefitting the Big Three, these provisions were intended to prevent domestic manufacturers from meeting their CAFE obligations without producing fuel-efficient autos. In reviewing the effect of this dual accounting system, US transportation authorities had found that it had created incentives for domestic manufacturers to shift production from their domestic to their imported fleets, by increasing the foreign content of their domestically produced autos: "The law, unfortunately, provides strong incentives for domestic manufacturers to import parts or to build the entire automobile outside US borders".[108] Manufacturers with both domestic and imported fleets could move a model from one fleet to the other to benefit the fleet with the lower CAFE by increasing or decreasing the production or assembly of parts in the United States or Canada. As the EC admitted, CAFE had had the "perverse" effect of sometimes discouraging the production by foreign manufacturers in the United States of high-mileage vehicles made with high US content. It had also induced domestic producers sometimes to shift low-mileage models into their import fleets.

3.299 The effect of CAFE's two-fleet rule was to adversely affect US manufacturers, who had to meet CAFE requirements for two fleets. Because US manufacturers could not average their domestic and foreign fleets together, they had to be concerned about the compliance positions of two separate fleets. On the other hand, as long as a foreign manufacturer kept the US/Canadian content of each model type below 75 per cent, it could average all its vehicles together for compliance purposes. This increased the foreign manufacturer's relative CAFE compliance

[108]53 Fed. Reg. 10,194 (March 29, 1988); DOT, Notice of Proposed Rulemaking, CAFE Standards for Model Years, 1989-1990, 53 Red. Reg. 33,080 (August 29, 1988).

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flexibility compared to US manufacturers. Indeed, as the EC noted, Japanese manufacturers with North American operations could produce relatively fuel-inefficient automobiles with less than 75 per cent US content and avoid CAFE penalties by averaging those autos with the rest of its "imported" fleet.

(iii) Article III:5

Separate foreign fleet accounting

3.300 The **European Community** argued that the separate fleet accounting rule also violated Article III:5, second sentence, which prohibited the application of internal quantitative restrictions "so as to afford protection for domestic production". The two-fleet rule was a clear violation of Article III:5 because it was an internal quantitative regulation that sought to dictate the composition of a manufacturer's overall production of vehicles and compelled domestic small car production. This was achieved by a requirement that the fleet-wide "average" attain the specified fuel economy level, 27.5 mpg, which was backed by a threat of stiff fines and penalties. By requiring that, for purposes of measuring compliance with CAFE, the fleet be wholly domestic or wholly imported, the two-fleet rule required the Big Three to produce small cars in the United States. This was the original purpose of the two-fleet rule, and the reason it remained in effect.

3.301 The Panel on *European Economic Community - Measures on animal feed proteins* examined a measure which required EEC producers or importers of oilseeds, dehydrated fodder and compound feeds, and importers of corn gluten feed to purchase a certain quantity of skimmed milk powder held by intervention agencies.[109] This measure tied the sale of one article to the sale of another article. CAFE averaging had the same effect since sales of large cars with low fuel economy had to be offset against sales of smaller, fuel-efficient cars. In effect, the averaging and two-fleet rules forced US manufacturers to build a corresponding number of domestic small cars to offset their US large-car production. The Panel concluded that the "measure … protected this product in a manner contrary to the principles of Article III:1 and to the provisions of Article III:5, second sentence."[110]

3.302 The **United States** noted that Article III:5, first sentence, prohibited mixing regulations that required a specific proportion of any product to be supplied from domestic sources. The second sentence established a binding obligation not to apply "internal quantitative regulations requiring the mixture, processing or use of products in specified amounts or proportions … to imported or domestic products so as to afford protection to domestic production". CAFE's separate fleet averaging requirement was not an internal quantitative regulation, since those who marketed automobiles in the United States were not required to manufacture any of them with US parts. The rules simply required US manufacturers to maintain one fuel-efficiency average across all automobiles manufactured with 75 per cent US content, and another identical average for autos manufactured with less than 75 per cent US content. The 75 per cent figure only established an amount which qualified autos as domestic for separate fleet accounting. There was no prohibition on either the import or manufacture of autos containing less than 75 per cent US content; the distinction did not create an intrinsic advantage of disadvantage; nor was a fleet of "imported" autos treated less favourably than a fleet of "domestic" autos. Rather, US manufacturers were given the option of either investing in the conversion of part of their fleet to production of small compact vehicles in the Unted States, if they chose to continue to produce a large number of fuel-inefficient autos, or else to raise by more gradual increments the fuel efficiency of the majority of

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[109]Panel report adopted on 14 March 1978, BISD 25S/49, para. 4.6.
[110]*Id* at para. 4.6.

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their domestic models. There was no discrimination involved; indeed about 15 per cent of automobiles sold in the US market were produced in the United States or Canada but considered "imports" for CAFE purposes. Moreover, there was no intrinsic advantage to a product's being considered in a foreign or domestic pool. Like the CAFE rules as a whole, the two-fleet rule was a regulation on manufacturing, and not a condition on the mixture or content of a particular product. As such, it was a trade-neutral rule relating to manufacturing and, as such, could not be inconsistent with Article III:5.

3.303 The EC ignored the distinction inherent in Article III between government activities to promote or regulate production and activities designed to discriminate against foreign products used in the production or the sale of such foreign products. To take the EC's argument to its logical conclusion, any measure promoting domestic manufacturing activities could be a violation of Article III simply because the products produced could displace imports. There was no support for such a view in Article III. Moreover, one of the key goals of government policies with respect to conservation and the environment, was to induce the private sector to change its habits with respect to what it produced, and how. The General Agreement clearly permitted this, provided it was done in a non-discriminatory manner.

3.304 The EC appeared to be asking the Panel to consider the two-fleet rule inconsistent with Article III:5, regardless of the domestic compliance policy purposes of the law, because the law was not crafted to provide special opportunities for imports. This logic plainly contradicted the purpose of Article III:1, which, as described above, was concerned with disparate treatment of regulations, and did not guarantee trade flows or more favourable treatment for imports. There was no evidence that CAFE's "two-fleet" rule was precluding US manufacturers from importing vehicles. Ford was importing small autos, such as the Festiva, from Korea; Chrysler was importing Colts and Summits from Japan; some European autos were being imported, such as Saabs by GM and Jaguars by Ford.

3.305 The **European Community** argued that there was no rule that "manufacturing requirements" were exempt from GATT disciplines regarding non-discrimination; the effects of such a rule would be unfortunate. If, for example, the EC announced a "manufacturing requirement" that any European manufacturer had to use exclusively parts and components manufactured within the Community, a GATT objection would be triggered because it would link the sale of one article to the sale of another. This would be inconsistent with the Panel decision in *EEC - Measures on animal feed proteins*, which found such linkage contrary to the provisions of Article III:5, second sentence[111]. Thus, the manufacturing requirement rule put forward by the United States should be rejected by the Panel.

3.306 As part of the two-fleet rule, the United States also required that any vehicle included in a manufacturer's US fleet contain 75 per cent domestic parts. This rule seemed out of place in a purely environmental law, which purportedly was shaped entirely by "legitimate" and "trade neutral" considerations. Not content with ensuring that the Big Three build small cars in America, the United States also sought to ensure that the Big Three's domestic fleets contained a substantial portion of US-built parts. It was particularly concerned that the Big Three might turn to assembling small cars from kits of imported parts, since this was the simplest and cheapest way of meeting a domestic automobile assembly requirement.

3.307 The trade damage arising from the 75 per cent rule occurred with respect to small car production by the Big Three. Because the Big Three had never been particularly interested in small car production, their technology and production methods in this area lagged behind that of

[111]BISD 25S/49, para. 4.6.

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the most efficient foreign producers. Accordingly, under normal circumstances, they might find it attractive to import small car parts, but the 75 per cent rule prevented this. The effects of both CAFE, in general, and the 75 per cent rule could be perverse. For some large automobiles such as the Crown Victoria, the two-fleet rule created an incentive to reduce domestic parts content, since this enabled Ford to shift a large, gas-guzzling automobile into its import fleet, where it could be offset by numerous small, fuel-efficient imports, like the Ford Festiva. For many Japanese-owned US manufacturers, the 75 per cent rule operated as a ceiling. The US manufacturing operations of companies like Honda, Toyota, and Nissan tended to produce vehicles with fuel economies below 27.5 mpg. Accordingly, they needed to keep these US-built vehicles in their import fleets, where they had credits from their Japanese production of small, fuel-efficient cars.

3.308 In any case, it was unnecessary to show how a measure would affect imports in each and every case. In the Panel on *United States - Section 337*, the United States had tried to argue that Section 337 might result in less favourable treatment for imports in some cases, but might lead to more favourable treatment in others. The Panel dismissed the argument, noting that "previous practice of the CONTRACTING PARTIES had been to base their decisions on the distinctions made by the laws, regulations or requirements themselves and on their potential impact, rather than on the actual consequences for specific imported products.[112] Thus, it was unnecessary to speculate as to the overall effects of the 75 per cent rule. If the rule truly benefited imports of auto parts, as the United States claimed, it should be easy for the United States to get rid of it.

3.309 The **United States** observed that the EC's argument that CAFE's separate fleet provision was a "manufacturing requirement" that contravened Article III:4 was contradicted by the EC's own stated view during the Uruguay Round TRIMS negotiations that manufacturing requirements were not covered by Article III. The United States recalled that the EC had taken this position in the Uruguay Round, notwithstanding its desire to see such measures prohibited. It noted that the EC's hypothetical example of a manufacturing requirement was, in fact, a local content requirement. In any event, the issue was not relevant to the case at hand because the separate-fleet provision was neither a local content requirement nor a manufacturing requirement, as nothing was "required" in this sense by the provision. There was no inherent advantage in being determined to be a part of a domestic versus an import fleet.

3.310 The EC had made a belated attempt to argue that the 75 per cent accounting threshold for the fleet requirement discriminated against imports of parts. This was clearly outside the Panel's terms of reference. Nevertheless, to set the record straight, between 1981 and 1992, US imports of auto parts in question rose from $1.6 billion to $35.6 billion a year. The top five auto parts suppliers were EC Member States; the top supplier was Germany.

3.311 The EC's allegation that the separate fleet requirement compelled production of smaller cars in the United States was unfounded. Indeed, the US manufacturers were able to meet CAFE requirements without abandoning large car production, by improving the fuel economy of their entire fleets. Even if the separate fleet rule did somewhat encourage small car production by US manufacturers, it would also do the reverse. Importers of large vehicles would also be encouraged to supply smaller vehicles for the US market. European cars were free to compete in that market on equal terms. Those European manufacturers that did produce smaller vehicles, such as Volkswagen, had never paid CAFE penalties.

3.312 The EC's argument that the separate fleet provision had discriminated against European small cars made the assumption, that absent this provision, US manufacturers would have

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[112]BISD, 36S/345, para. 5.13.

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complemented their fleets with European small cars. This contradicted the EC's acknowledgment that such cars have not been competitive in the US market. While this allegation could reflect a concern on behalf of Japanese imports, statistics showed that Japanese small car exports to the United States had not been adversely affected.

3.313 The facts did not support the EC's attempt to show a protective effect of the separate fleet rule. The share of all cars sold in the United States and classified as "imports" rose from 18.5 per cent in model year 1978 to 42.5 per cent in model year 1992. The EC's invocation of the Section 337 panel report to argue that lack of protective effect was not fatal to its case, was inapposite, because that case involved different treatment for imports and domestic products. The standards for an imported and domestic fleet were identical here, and the separate fleet requirement had no detrimental effect on imports.

(iv) Article XX(g)

3.314 The **European Community** noted that the party seeking to invoke an exception to GATT disciplines under Article XX had the burden of establishing that the measures qualified. The EC fully accepted and supported the conservation of carbon fuels as a legitimate environmental goal; however, the CAFE program did not satisfy the relevant requirements under Article XX(g), and failed each of the four tests described under the discussion of the gas guzzler tax for invoking Article XX(g).

3.315 The **United States** reiterated that the EC had not, and could not, establish that the CAFE measures were inconsistent with the General Agreement. Thus, there was no need for the Panel to consider the applicability of Article XX to these measures. However, it was obvious from the facts presented above that, as a central element of US energy conservation policy, the CAFE measures were also measures within the scope of Article XX(g). The points made below were also relevant.

(a) relating to the conservation of an exhaustible natural resource

3.316 The **European Community** argued that the same approach as with the finding of the Panel on *United States - Section 337* regarding Article XX(d) should be adopted with respect to the "relating to" requirement of Paragraph (g). This Panel found that Article XX(d) required a contracting party to show that each element of its program was "necessary", as opposed to showing that an overall system for enforcing intellectual property rights was "necessary". The Panel pointed out that a systemic approach "would permit contracting parties to introduce GATT inconsistencies that are not necessary simply by making them part of a scheme, which contained elements that are necessary."[113]

3.317 Also, according to the Panel on *Canada - Herring and salmon*, a measure could be considered to be "related to the conservation of an exhaustible natural resource", if it was "primarily aimed" at the conservation of such resource.[114] This Panel had relied on the selective application of the Canadian export restrictions in determining that the measures were not primarily aimed at controlling domestic production or consumption of unprocessed fish, but instead appeared designed to ensure adequate supplies of such fish for the Canadian processing industry. With respect to CAFE, the US reliance on fleet-wide averaging led to a discriminatory tax burden on imported European vehicles that was inconsistent with Article III:2. Because importers of autos and many other products tended to be much more specialized than domestic manufacturers

[113]*Id* at para. 5.27(c).

[114]BISD 35S/98, para. 4.6.

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of like products, it led to different CAFE penalties on like automobiles, and had an effect similar to *Canada - Herring and salmon*. The use of averaging did not advance, and in some respects undermined, the goal of energy conservation because it permitted full-line manufacturers to sell large numbers of cars with high fuel consumption, as long as they were counterbalanced by production of smaller cars.

3.318 While GATT Panels should be careful not to second-guess the energy policy choices of individual contracting parties who may need flexibility to adapt measures to local needs and conditions, they had a fundamental responsibility to ensure that the requirements of Article XX(g) were complied with and not abused. The EC considered that there were non-discriminatory means of limiting demand for carbon fuels, such as a gas tax or a tax on individual vehicles that corresponded to some objective measure of fuel consumption. A gas tax was inherently non-discriminatory, since all vehicles with the same fuel consumption faced the same disincentive. Similarly, a tax based on individual fuel consumption would lead to the imposition of like taxes on vehicles with like fuel economy ratings. It would have a continuing effect on gasoline consumption, as opposed to the one-time impact of a tax on the sale or production of a vehicle. Either approach would avoid the situation that arose under CAFE where a European vehicle was subject to the high CAFE penalty, while a US vehicle with like fuel economy escaped the penalty because it was subsumed in a larger fleet-wide average for the Big Three. The effect of the US approach was to confer a commercially significant, competitive advantage on the like US automobile.

3.319 The **United States** noted that the EC had admitted that it "did not contest the validity of the environmental protection objectives of" the CAFE requirements. As described by the Panel on *Canada - Herring and salmon*, the purpose of Article XX(g) was "merely to ensure that the commitments under the General Agreement did not hinder the pursuit of policies aimed at conservation of exhaustible resources". In keeping with this purpose, the Panel concluded that in order for a trade measure to be considered as "relating to" the conservation of an exhaustible resource in conformity with Article XX(g), it did not have to be "necessary" or "essential" to the conservation of an exhaustible natural resource, but must be "primarily aimed at" its conservation.[115]

2.320 The CAFE and gas guzzler programs in combination provided an appropriate and reasonable means for the United States to conserve fuel in the transportation sector. Improving the fuel efficiency of the fleet was a necessary component of a transportation energy conservation program. Without increased fuel efficiency, the only mechanism available to reduce fuel consumption was to reduce travel. Relying on taxing fuel alone would be regressive (on lower income Americans) and would not produce the technological innovation that ensures fuel conservation in the long term. Moreover, this approach would not be possible in as large a country as the United States, with spread out population centres, a growing population and growing economy. The drastic measures that would be necessary to reduce fuel consumption only through reduced travel would critically damage the US economy. Nothing in the General Agreement required a contracting party to adopt draconian measures simply because that approach was hypothetically more convenient to certain manufacturers in the territory of another contracting party.

3.321 The CAFE program was primarily aimed at US fuel conservation and thus fell within the scope of Article XX(g) since from the beginning its purpose had been to raise the overall fuel efficiency of vehicles in the United States in order to conserve fuel. As the Administrator of the US EPA admonished in 1975, when addressing the US Senate Commerce Committee: "if we are

[115]*Id* at para. 4.6.

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unwilling to face up to the problem of the automobile, we might as well forget about the goal of energy conservation." Moreover, the effect of the CAFE requirements on the US market showed that the program had achieved its objective: in 1974, the average fuel economy of passenger vehicles in the United States was approximately 14 mpg; today it was 28.3 mpg. Between 1978, when the CAFE measures took effect, and 1990, passenger autos total annual fuel consumption in the United States declined by 11 per cent even though passenger autos total registrations increased by 23 per cent and total miles travelled by passenger autos increased by 32 per cent.[116] Such changes could not have happened without a law that was specifically aimed at encouraging the development and production of fuel-efficient vehicles.

3.322 With continued growth in population and vehicle travel, light vehicles in the United States still accounted for close to 7 million barrels per day of oil consumption. Excessive fuel consumption was a serious problem in the United States and fuel conservation remained an important objective of US policy. Fossil fuels were an exhaustible natural resource and total US and global reserves were limited. The disproportionate contribution of fuel consumption to the threat of global climate change had lent further support to the US goal of fuel conservation. The US fuel economy requirements had been recognized internationally as a success not only in reducing US oil consumption but also in reducing emissions of carbon dioxide and other gases contributing to global warming and ozone depletion.[117]

3.323 Carbon emissions from the US transportation sector alone accounted for 7 per cent of global emissions and exceeded the quantity of emissions produced by the entire nation of Japan. The US EPA acknowledged the critical linkage between climate concerns and fuel economy regulation when it announced the end to CAFE rollbacks in 1989, noting that "vehicle energy efficiency improvements were likely to be a major component in any future domestic or international response to concerns about carbon dioxide".[118] Concern about global climate change was documented by extensive scientific literature and was widely accepted in the international community. This concern had led the United States and over 150 other countries to pledge joint action to protect the earth's atmosphere under the United Nations Framework Convention on Climate Change. In listing the multiple benefits of reduced vehicle fuel consumption, a recent study by the National Academy of Sciences included reduced consumer expenditures, conservation of resources, enhanced national security, improved environmental quality, enhanced diffusion of technology and increased economic efficiency.[119]

(b) Made effective in conjunction with restrictions on domestic production and consumption

3.324 The **European Community**, referring to its above arguments on the gas guzzler tax, noted that the Panel on *Canada - Herring and salmon* found that a measure could only be said to have been made effective in conjunction with restrictions on domestic production and consumption, if it was primarily aimed at rendering effective these restrictions.[120] As explained above, the CAFE requirements were not "primarily aimed" at conserving a natural resource.

3.325 CAFE requirements did not represent a direct restriction on the production or consumption of gasoline; there was only a limited relationship between fuel economy standards and gasoline

[116]"National Transportation Statistics", Annual Report, 1990 and 1992, U.S. Department of Transportation, Research and Special Programs Administration.

[117]International Energy Agency, Energy Efficiency and the Environment (1991) pg. 80, 135, 159.

[118]54 Fed. Reg. 21989 (May 22, 1989).

[119]National Research Council, National Academy of Sciences, "Automobile Fuel Economy: How Far Should We Go?" National Academy Press (1992) pg. 170.

[120]BISD 35S/98, para. 4.6.

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consumption. While CAFE had contributed to some improvements in US automobile fuel economy, US consumption of oil and gasoline had continued to rise sharply.[121] Purchasers of large autos with low fuel economy may use a car exclusively to drive short distances; consumer research suggested that many purchasers of large European cars purchased them primarily because of safety considerations. In contrast, a small car could be driven for long distances and consume large amounts of fuel. In addition, if fuel was cheap, as was the case in the United States, there was every incentive for consumers to drive long distances, use cars instead of mass transit for commuting purposes, and own multiple vehicles. A one-time penalty might encourage manufacturers to produce, and consumers to buy, more fuel-efficient cars, but it could not offset the effects of low US gasoline prices on gasoline consumption. CAFE did not create disincentives to long distance driving or excessive consumption of gasoline. Accordingly, CAFE was not part of a comprehensive domestic program for controlling sources of consumption of carbon fuels.

3.326 Unless the United States brought itself into conformity with Article XX(g) by directly regulating gasoline consumption or production, it was highly unlikely that US fuel conservation objectives would be realized. Instead, US consumers would continue to take advantage of cheap gasoline prices by consuming excessive quantities with detrimental consequences for the environment and global oil stocks. CAFE addressed excessive US carbon fuel consumption by restricting a secondary product, autos, instead of directly regulating US consumption of the resource in question. Even so, the CAFE regulations, like the gas guzzler tax, were not part of a comprehensive US program of restrictions on the secondary sources of oil consumption.

3.327 The **United States** argued that conservation of fuel through the domestic production of fuel-efficient vehicles was a primary concern of the CAFE measures. In order to reduce consumption of fuel, the United States, through the CAFE measures, placed considerable burdens on domestic manufacturers to double the fuel efficiency of their fleets. Application of the CAFE requirements to imports was essential to avoid nullifying the reduced consumption of fuel resulting from the application of the CAFE measures to domestic manufacturers. Accordingly, the measures were "primarily aimed at rendering effective" the restrictions on domestic production or consumption.

3.328 Further, the EC did not provide a basis or precedent in the language of Article XX(g) that it should be read to require a government to directly restrict consumption or production, rather than promote conservation "indirectly" through "secondary measures". Either measures were "primarily aimed at" the conservation of exhaustible natural resources or they were not. As the EC had acknowledged, CAFE measures had valid environmental protection objectives. Since they were admittedly "relating to the conservation of exhaustible natural resources", they were within the scope of Article XX(g).

3.329 Contracting parties had to be given latitude in deciding the best means to accomplish their conservation objectives, as long as the measures selected were not applied so as to constitute a means of arbitrary or unjustifiable discrimination between countries where the same conditions prevailed, or a disguised restriction on international trade. The CAFE measures were part of a comprehensive US conservation policy. In the transportation sector, complementary polices included taxes on petroleum-based motor fuels and subsidies for some alternative fuels, such as ethanol. The United States also required that government and many private fleets purchase alternative fuel vehicles. In addition, the United States in 1992 also increased the already substantial US commitment to research and development of alternative fuels and high-efficiency vehicles by several hundred million dollars per year.

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[121] *Options for Reducing Oil Use by Light Vehicles: An Analysis of Technologies and Policy* (Dec. 1991), pg. 34.

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(c) *Arbitrary or unjustifiable discrimination between countries where the same conditions prevail*

3.330 The **European Community** argued that the CAFE regulations constituted arbitrary and unjustifiable discrimination against European cars. Like the 22.5 mpg threshold of the gas guzzler tax, the 27.5 mpg threshold of CAFE had no serious basis in tax or energy policy. Originally the threshold was at a lower level, but it had remained constant at 27.5 mpg for many years, primarily because any greater stringency might have subjected the Big Three to penalty payments for the first time. CAFE penalties were virtually exclusively paid by European manufacturers because they were limited-line carmakers and therefore unable to engage in fleet-wide averaging. Therefore, the discrimination against them was based on an arbitrary criterion that was designed to spare US manufacturers and effectively hit only European car-manufacturers.

3.331 The **United States** emphasized that the CAFE measures applied equally to fleets of all countries, and therefore was not discriminatory. CAFE constituted a reasonable approach to long-term fuel conservation by passenger vehicles in the United States. The fleetwide averaging system required manufacturers to increase their fuel efficiency while preserving their ability to respond to consumer demand and choice. Averaging provided all manufacturers with compliance flexibility, without undermining fuel conservation. There was no "discrimination" between European products on the one hand, and US or other foreign sources products, where the same conditions prevailed, on the other hand.

3.332 The EC's claims that the averaging approach was unjustifiable, and that the 27.5 mpg threshold had no "serious basis in tax or energy policy" were frivolous and misdirected. There was no question that the CAFE measures had resulted in real, substantial conservation of fuel. Furthermore, each contracting party was free to set the level of resource conservation that it determined appropriate. It was not for the EC to attempt to substitute its judgement for that of another contracting party. The EC was attempting to create a new test of "arbitrary" with respect to the level of conservation selected, and to persuade this Panel that the General Agreement required that all manufacturers be affected identically. Both attempts were based on a fundamental misreading of Article XX and of the General Agreement and should be rejected. The General Agreement contained no such requirements nor would such requirements make any sense in light of, or be consistent with, the purposes of the General Agreement.

3.333 The fact that not all manufacturers were identically situated was an immutable aspect of the market place. In many instances some manufacturers may be able to more easily comply with particular measures than others. Under the EC's approach, whenever manufacturers in another country were less well situated to comply with a contracting party's measures, there would be an inconsistency with the General Agreement and the contracting party would be required to adapt its measures to the situation of the other manufacturers. This was absurd and would mean that the business choices of particular companies could determine whether a contracting party's measures were consistent with the General Agreement, and that the consistency of those measures would change as particular companies altered their production decisions. The Panel should reject this approach.

3.334 The 27.5 mpg threshold was based on the potential for improving the average fuel economy of American automobiles, which was 14 mpg for model year 1974. The United States set 27.5 mpg as the requirement for model year 1985 and thereafter because the available evidence had indicated that the auto industry could double passenger car average fuel economy by that time, making an enormous contribution to fuel conservation in the United States.[122] The

[122]H. Rep. No. 340, 95th Congress, 1st Sess. 86 (1975).

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accomplishment of this goal was proof of the rational basis for the CAFE requirements. The chart below showed that the average fuel economy of all passenger autos sold in the United States had doubled since the CAFE measures were adopted:

Increase in Passenger Car Fuel Economy
(percentage of new car sales by level of fuel economy)

Range of Fuel Economy	Model year 1978	Model year 1993
< 18 mpg	28.0	0.1
≥ 18.0 mpg, < 20.0 mpg	29.6	0.6
≥ 20.0 mpg, < 22.5 mpg	18.5	1.9
≥ 22.5 mpg, < 25.0 mpg	6.0	14.2
≥ 25.0 mpg, < 27.5 mpg	6.8	28.3
≥ 27.5 mpg, < 30.0 mpg	3.2	20.9
≥ 30.0 mpg, < 35.0 mpg	4.1	23.1
≥ 35.9 mpg	3.9	10.9
Total	100.1	100.0

3.335 The fuel conservation basis for the 27.5 mpg threshold had not been diminished, nor negated by the passage of time or by the decision thus far not to raise the requirement. Further, neither of these factors diminished the fuel conservation benefits that continued to flow from the 27.5 mpg requirement. The question of whether it should be raised for future model years was not an issue for this or any other panel proceeding. It was an issue that had been considered by the United States during several recent years, and was likely to continue to be a subject of much debate in the future. The EC's claim that the requirement had stayed at 27.5 mpg because any higher level might subject the Big Three to penalties was not only irrelevant and baseless. The debate on higher requirements had focused on issues such as the technological feasibility and economic practicability of higher requirements and their impact on vehicle safety.

3.336 Decisions whether to comply by individual manufacturers determined whether penalties were imposed. If some European manufacturers had paid more penalties than other manufacturers, it was because they marketed a disproportionate amount of fuel-inefficient automobiles, and had failed to increase their vehicles' fuel efficiency as required. These particular EC manufacturers paid penalties because they had chosen not to comply with the CAFE requirements, not because the CAFE requirements were applied in a manner that constituted "arbitrary or unjustifiable discrimination".

(d) Disguised restriction on trade

3.337 The **European Community** argued that the CAFE system was a disguised restriction on trade. Under a seemingly objective system of penalty payments, it hit only imported goods produced by European manufacturers and thus shielded "like" US products from competition. The purpose of the separate-fleet accounting distinction was to prevent "runaway" plants and thereby preserve US small car production and employment. This particular aspect of CAFE thus constituted a thinly-disguised trade barrier. The legislative history also demonstrated the lack of connection between the separate-fleet accounting distinction and the objectives of conserving energy and making effective restrictions on domestic energy consumption, which must be shown in order to satisfy Article XX(g). If the goal of CAFE was to promote conservation of carbon fuels, the origin of the vehicle should be irrelevant. Indeed, creating barriers to the importation of fuel-efficient small cars undermined, rather than advanced, energy conservation.

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3.338 The **United States** argued that the objective of the CAFE measures was to conserve fuel, not to serve as a disguised restriction on trade. These were transparent, trade-neutral conservation measures. Yet the EC asserted that under the guise of what was clearly an objective, non-discriminatory system, the CAFE measures were intended to adversely affect only imported goods produced by a few European manufacturers. This assertion could not stand, particularly in light of the major investments in new technology required by the CAFE measures of US automakers; CAFE's detailed methodology for measuring and ensuring progress in fuel efficiency; and its enforcement mechanisms that went to great lengths to encourage compliance.

3.339 The use of fleet averaging was also not a disguised restriction on international trade. There was no evidence when the CAFE measures were adopted that this method of calculating compliance would benefit domestic manufacturers in comparison to foreign manufacturers. In 1975, domestic manufacturers produced very few small, fuel-efficient vehicles. As discussed above, some European manufacturers paid penalties because, since the mid-1980's, they had chosen to ignore the US fuel economy law and had made no effort to produce or sell more fuel-efficient vehicles to offset less fuel-efficient ones. There was no trade "restriction" involved, as the US market shares of the two largest EC manufacturers of luxury cars varied over the years without any relation to U.S. fuel economy requirements. In fact, CAFE measures had affected domestic manufacturers far more severely than European ones, since domestic manufacturers had incurred compliance costs of millions of dollars while some European manufacturers had chosen to pay civil penalties. Meanwhile, CAFE had also burdened the domestic industry relative to its major sources of foreign competition, which were able to comply without incurring any costs.

3.340 The CAFE measures, combined with the gas guzzler tax, had been extremely effective at restraining the growth of US demand for fuel in the transportation sector. In 1980 the National Highway Traffic Safety Administration (NHTSA) projected cumulative automobile fuel savings of 9.4 billion barrels from model years 1978 through 2000 as a result of the US fuel economy requirements. Had the average efficiency in the nation's new light duty vehicle fleet not doubled in the years since 1975, overall fuel consumption would have been almost 28 per cent (or 3 million barrels a day) higher, and the United States would have added an additional 120 million metric tons of carbon (out of a total of 1,450 million metric tons) to the atmosphere each year. The European manufacturers that were flouting the CAFE requirements were not contributing to this conservation effort.

(e) Article XX(g) and the two-fleet and 75 per cent parts rules

3.341 The **European Community** argued that the United States should be required to show that the separate fleet accounting rule and the 75 per cent parts rule were justified by Article XX(g). Neither rule had anything to do with energy conservation or environmental protection, and protected US small car and auto parts producers. Even if the Panel concluded that CAFE itself may qualify under Article XX(g), it should examine specifically whether these two individual elements of CAFE were also covered. Unless the United States could show that they were necessary elements of its environmental program and met each and every requirement of Article XX(g), they should be condemned by the Panel.

3.342 The **United States** explained that the fuel conservation objective of separate fleet accounting methods was to ensure a long term fuel-efficiency policy by requiring US manufacturers to change their production. None of the alternative measures penalizing individual vehicles proposed by the EC provided the same range of policy benefits as the CAFE measures. Nothing in the General Agreement required a contracting party to adopt a particular measure simply because it may be hypothetically more convenient to certain manufacturers in the territory of another contracting party.

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(v) Article XX(d)

3.343 The **United States** noted that under Article XX(d), Article III may not be construed to prevent the adoption of measures that were necessary to secure compliance with laws or regulations that were not inconsistent with the provisions of the General Agreement. The assessment of penalties to secure compliance with fleet averaging requirements, that, as demonstrated, were consistent with the General Agreement, was clearly required to secure compliance. These penalties were applied on strictly-defined criteria, did not discriminate among countries, and were not a disguised restriction on trade. The effort made by the CAFE program to secure compliance, relieving companies of any obligation to pay penalties if they submitted a plan to market more fuel-efficient vehicles, encouraged all manufacturers, including those of imported products, to avoid them. Indeed, judging from the fact that the market shares of Mercedes and BMW actually increased at the same time as CAFE requirements were raised, there was in fact no restriction on trade at all. If anything, the penalties had not been high enough to prevent the marketing of fuel-inefficient vehicles from the EC.

3.344 The **European Community** argued that under Article XX(d) a measure which itself was contrary to the GATT could be excused if it was necessary to secure compliance with a law or regulation which was in conformity with the GATT. This case was not about the GATT conformity of the penalty payment of CAFE as such, but about the conformity of the underlying legislation, of which the averaging methodology and the separate fleet accounting provisions were not in conformity with the GATT. This case was not like Article 337, the subject of examination in the Panel on *United States - Section 337*, where the enforcement mechanism was at stake and not the US patent law.[123]

D. Cumulative Effect of the Three Automobile Taxes

3.345 The **European Community** argued that the effects of each of the three measures (the luxury and gas guzzler taxes and the CAFE requirements) were exacerbated by the fact that many cars were subject to all three taxes. In fact, the gas guzzler tax was considered part of a vehicle's sales price for determining any luxury tax. The financial burden of the taxes, in combination, was substantial. For example, in 1992, the latest year for which data were available, the Luckey study showed the gas guzzler and luxury tax burdens on selected European automobiles as follows:

Model	MSRP	Gas Guzzler Tax	Luxury Tax
Mercedes 300SE	$ 69,400	$2,100	$ 3,451
Mercedes 400E	$ 55,800	$1,300	$ 2,166
BMW 535i	$ 44,350	$1,000	$ 1,097
BMW 735i	$ 52,990	$1,300	$ 1,911
Jaguar XJS	$ 64,500	$3,000	$ 3,092
Porsche 911	$ 78,177	$ 501	$ 4,066
Maserati 430	$ 43,925	$2,100	$ 1,174
Ferrari Testarossa	$169,000	$5,400	$12,603
Rolls Royce Silver Spur	$167,600	$5,400	$12,464

3.346 These cars also had to bear the burden of part of the CAFE fines paid by their manufacturers thus suffering from a treble tax exposure in the United States. This situation had contributed to a sharp decline in sales of large expensive European automobiles in the US market. "Like" and certainly competitive and substitutable American cars did not suffer from this treble

[123]BISD 36S/387.

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tax exposure. None of the products of the "Big Three" had to shoulder the burden of the three taxes simultaneously, since they never paid CAFE fines and several of their cars with consumption below 22.5 mpg did not pay gas guzzler tax either. The EC considered that, for these reasons, the cumulative effect of the three taxes was contrary to Article III:2, first sentence, and at the very least contrary to Article III:2, second sentence.

3.347 In conclusion, the United States had failed to meet all four conditions for invoking Article XX(g). To implement a GATT-consistent conservation program, the United States could adopt a trade-neutral gas tax, or it could improve its automotive environmental standards by applying fuel economy fines on a vehicle-by-vehicle basis. Either system would be trade-neutral and would ensure like treatment of like automobiles. In addition, these types of systems would improve environmental enforcement by penalizing all vehicles with high fuel consumption, instead of letting some vehicles escape through regulatory loopholes.

3.348 The **United States** argued that where each measure was consistent with the General Agreement, "cumulation of effects" did not amount to a violation of national treatment obligations. The Panel on *Canada - Alcoholic drinks* had addressed a situation where an *ad valorem* tax had resulted in consistently higher taxes on imported products because charges for services specific to imports had been included in the computation of the product's value. The Panel decided that since the underlying charges for the services were not inconsistent with the General Agreement, neither was their inclusion in the price computation of the product for purposes of assessing the tax. Similarly, here, the combined effects on certain European manufacturers of the CAFE requirements, gas guzzler tax and luxury tax were irrelevant, since these measures were themselves each consistent with the General Agreement.[124]

IV. THIRD PARTY SUBMISSIONS

Sweden

4.1 Sweden shared the concerns that had led the EC to initiate the dispute settlement process concerning US taxes on automobiles. After a thorough investigation of the matter, Sweden had concluded that the complaints presented by the EC were valid. Sweden supported the basic thrust of the legal arguments and the conclusions presented by the EC. It was Sweden's opinion that the US luxury tax, the gas guzzler tax and the CAFE-program were not consistent with the US obligations in accordance with GATT Articles III and XX.

A. Luxury tax

4.2 Sweden agreed that the luxury tax was imposed in a *de jure* non-discriminatory manner in so far as all vehicles, imported and domestic, that sell for over $30.000 were subject to the tax. The effect, however, was *de facto* discrimination since most domestic cars were priced below this level and the tax thus fell disproportionately hard on European cars, including Swedish ones, which were generally priced above the $30.000 limit. (In 1991 and 1992 European cars accounted for 76.82% and 69.54% respectively of the luxury taxes paid, while US manufacturers paid only 7.15% and 10.63%.)

4.3 Sweden supported the EC view that the $30.000 threshold was an arbitrary and artificial limit that did not correspond to objective product differences. Autos below as well as above this limit could be like products. The discrimination was underlined by the fact that many US cars

[124]BISD 39S/27, para. 5.24.

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below the $30.000 threshold were labelled "luxury cars", but were not liable to pay the luxury tax. As was shown in the EC's submission, several US car manufacturers (Ford, GM and Chrysler) advertised models like the Chrysler New Yorker, the Buick Park Avenue and the Oldsmobile 98 as "luxury cars", although they were priced below $30.000.

4.4 The luxury tax constituted a violation of Article III:2, first sentence, since it had a disproportionate impact on imported vehicles, resulting in a much greater tax burden on European cars than on like domestic cars, thus giving US manufacturers a competitive advantage.[125] Sweden also supported the view that since the tax had the effect of affording protection to the American auto industry it was in violation of Article III:2, second sentence. The second sentence of paragraph 2 prohibited discriminatory internal taxation that distorted trade between directly competitive or substitutable products -in this case European and American "luxury cars"[126].

Environmental policies and measures

4.5 Sweden noted that in the field of environmental policy, economic instruments such as fees and taxes were increasingly being used by governments to achieve environmental goals. The American fuel efficiency taxes, like the gas guzzler tax and the CAFE program, were no exceptions. Sweden acknowledged, in accordance with Agenda 21 and the Convention on Climate Change, the need for abating emissions of green house gases, such as CO_2-emissions from cars and supported the introduction of measures to reach this goal. Sweden objected, however, to the use of trade distorting measurers to reach environmental goals. Sweden considered that the US implementation of the gas guzzler tax and the CAFE program was clearly targeted at reducing the competitiveness of imported cars on the US markets.

B. Gas guzzler tax

4.6 Regarding the gas guzzler tax, Sweden supported the view that this tax violated Article III:2, first and second sentence. The United States had chosen to selectively tax a small segment of US auto sales based on an arbitrary gasoline consumption threshold. This meant that the United States did not have a general, trade-neutral system for taxing vehicles according to gasoline consumption. The EC had shown quite clearly that the principal effect of the tax had been to target imported European autos, which was a violation of Article III:2, first sentence. An important US objective, that had evolved over time, had clearly been the raising of revenues, primarily at the expense of foreign car producers.

4.7 The EPA methodology of using "model types" when calculating liability for the tax, involved *de facto* discrimination against imported vehicles in violation of Article III:2. The "averaging" included in the EPA regulations (offsetting cars with a poor mileage per gallon with more fuel-efficient configurations within the same model type) meant that full-line US manufacturers could escape the tax. This method could not be used by European manufacturers that sold a much narrower range of cars on the US market. Sweden therefore supported the conclusion that the gas guzzler tax led to the imposition of severe financial penalties on imported European cars, while exempting like US-built models with the same or worse fuel economy.

4.8 Sweden considered that the application of the tax also violated Article III:2, second sentence, by disrupting competition between directly competitive or substitutable products, namely

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[125]Report of the Panel on *Japan - Customs duties, taxes and labelling practices on imported wines and alcoholic beverages*, BISD 34S/83, para. 5.9.

[126]*Id* at para. 5.7.

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cars with similar or comparable emission levels, thus affording protection to domestic production, contrary to the principles of Paragraph 1.

C. Corporate Average Fuel Economy

4.9 Sweden agreed with the EC that the CAFE program was constructed in such a way as to provide protection to the US manufacturers through the use of a calculating methodology highly favourable to them. The use of averaging thus favoured US manufacturers which all have smaller models that compensated for bigger, more gas guzzling ones. European manufacturers, including one Swedish manufacturer, almost exclusively sold medium sized or large models on the US market and were therefore not able to engage in fleet-wide averaging.

4.10 Although the US industry, like the Swedish industry and indeed all car manufacturers, had invested large amounts of money in changing model programs, these were not all a result of CAFE demands, but also due to changes in the US consumers' product demands. All European car manufacturers, including Swedish ones, had spent large sums on research and development in order to introduce new technology and improve their vehicles from an environmental point of view.

4.11 Sweden supported the view that the EPA methodology set standards that European firms did not have a fair chance to meet. Article III, paragraph 4, stated:

> that imported products "shall be accorded treatment no less favourable than that accorded to like products of national origin in respect of all laws, regulations and requirements affecting their internal sale, offering for sale, purchase, transportation, distribution or use.

In the implementation of the CAFE program, European cars had not been granted effective equality of competitive opportunities on the US market and the program was therefore in violation of Article III:4.[127] European manufacturers had furthermore had to bear the whole burden of the CAFE tax, while American products with the same or worse mileage had escaped paying the tax. This discrimination constituted a clear violation of Article III:2.

Article XX

4.12 Sweden noted that Article XX(g) provided a possibility to adopt measures relating to the conservation of exhaustible natural resources. Article XX(g) had been invoked by the United States concerning the gas guzzler tax as well as the CAFE tax. The objective of conserving exhaustible natural resources was warmly welcomed by Sweden which fully supported the use of Article XX to this end. However, in Article XX it was clearly stated that measures adopted must not "constitute a means of arbitrary or unjustifiable discrimination between countries where the same conditions prevail, or a disguised restriction on international trade". Article XX(g) also stated that measures taken should be "made effective in conjunction with restrictions on domestic production or consumption".

4.13 Sweden firmly believed that the above requirements in Article XX had not been fulfilled in the design and implementation of the US gas guzzler tax and the CAFE program. The objective of controlling the consumption of gasoline should be achieved by non-discriminatory and trade-neutral methods. The requirements for fuel economy could, for instance, be placed on each

[127] *US - Section 337 of the Tariff Act of 1930*, BISD 36/345, para. 5.11 and *Canada - Import, distribution and sale of certain alcoholic drinks by provincial marketing agencies*, BISD 39S/27, p. 59.

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individual vehicle without an "averaging loophole", an approach that had been also proposed in the US Congress in September 1990 by Senator Durenberger. This approach was unfortunately rejected after strong lobbying by US cars manufacturers. Another way to stimulate the use of more fuel saving vehicles would be to place higher taxes on fuel. These measures would not have a "disproportionate impact" on Swedish or other imported vehicles, as vehicles with similar environmental performance would be treated equally. If Swedish vehicles were then more affected than US or other vehicles, this would exclusively be due to poorer fuel economy and not because they were not included in a wide enough fleet.

V. FINDINGS

A. Luxury Tax

5.1 The Panel noted that the issues in dispute with respect to the luxury tax arose essentially from the following facts, as described more fully in Part II of this report. In 1990, the United States Omnibus Budget Reconciliation Act imposed a retail excise tax on certain luxury products, amounting to 10 percent of the excess of the retail price over a fixed threshold value. These luxury products included passenger vehicles, boats, aircraft, jewellery and furs. A threshold level of $30,000 was fixed for passenger vehicles, which covered any four-wheeled vehicle manufactured primarily for use on public streets, roads, and highways, and weighing 6,000 pounds or less. The tax did not apply to the sale of any passenger vehicle for trade, business and certain other purposes. In 1993, after the establishment of the Panel, a further Omnibus Budget Reconciliation Act repealed the retail excise tax on boats, aircraft, jewellery and furs. Passenger vehicles, the only product remaining subject to the tax, were made subject to an increased threshold of $32,000 to compensate for inflation.

5.2 The Panel noted the EC view that the luxury tax imposed by the United States on domestic and imported automobiles sold for over $30,000 violated Article III:2 of the General Agreement. The EC argued that automobiles costing over $30,000 were like products to automobiles costing less, since they had the same end use, basic physical characteristics, and tariff classification. Further, a mere difference in price between the imported and domestic products was not sufficient for those products to be considered unlike for the purposes of Article III. The price threshold of $30,000 would in addition have to be shown to be based on objective product differences, and to be part of a general system of internal taxation equally applied in a trade-neutral manner to all like or directly competing automobiles. According to the EC, the United States measure was not based on objective product differences, since luxury cars were found above and below the $30,000 threshold. They were also not applied in a trade-neutral manner, since automobiles were singled out as a product for less favourable tax treatment, and EC automobiles were in particular targeted. The disproportionate burden borne by EC automobiles was shown by the proportion of EC automobiles subject to the tax, the proportion of revenues generated by EC automobiles, and the average tax paid per EC luxury automobile. The EC further considered that, under the terms of Article III:2, second sentence, and the Note ad Article III, domestic automobiles under $30,000 were afforded protection, since they competed with and were "directly competitive and substitutable" to imported automobiles costing more.

5.3 The Panel noted also the United States view that the luxury tax did not violate Article III. In determining whether automobiles over $30,000 were "like" those selling for less, the United States argued that it was necessary only to determine whether the threshold had been applied "so as to afford protection to domestic production." The purpose of Article III was not to prevent contracting parties from differentiating between products for policy purposes unrelated to the protection of domestic production. Further, the United States argued that Article III only

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protected expectations on competitive conditions resulting from government measures. It did not guarantee specific levels or proportions of trade, nor the results in the market of particular choices made by companies. The United States also argued that, even if the trade impact of the luxury tax were considered relevant to the determination of obligations under Article III:2, figures showed that automobiles of foreign origin were not disproportionately affected by the measure.

(i) Article III:2, first sentence

5.4 The Panel proceeded to consider whether the luxury tax maintained by the United States was consistent with Article III:2, first sentence, which states:

> "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."

The Panel found, and the parties agreed, that the luxury tax applied by the United States came within the scope of "internal taxes or other internal charges", and that imported automobiles selling for more than $30,000 were subject to the tax. The parties disagreed, however, on whether automobiles selling at prices above and below this threshold were like products in terms of Article III:2. The EC claimed that automobiles above and below the threshold were like products, since they had the same physical characteristics, end-use, and tariff classification. The threshold level was not based on objective product differences, nor applied in a trade-neutral manner. The United States disagreed with this approach, arguing that the tax could be imposed on the basis of a threshold of $30,000, as long as the tax was not applied so as to afford protection to domestic production.

(a) Treatment of like products under Article III

5.5 The Panel noted that the central issue raised by the parties was whether under Article III:2 cars selling for more than $30,000 were "like" products to domestic cars selling for less. The resolution of this issue required a preliminary analysis of the scope of Article III with respect to the treatment to be accorded to a product of foreign origin. The Panel proceeded to examine the terms of Article III. It observed that Article III deals with differences in treatment between products. These differences in treatment resulted from regulatory distinctions made by governments. If regulatory distinctions were drawn explicitly with respect to the origin of the product, or with respect to manifestly different products, then the consistency with Article III:2 or 4 could be determined in a straightforward manner. If the regulatory distinctions were not drawn explicitly with respect to origin, then it had to be determined whether the products were "like". The Panel recalled the EC argument that likeness of products under Article III should be based on factors such as their end use, physical characteristics and tariff classification, and that the disproportionate impact of the measure on a foreign product is relevant in determining the overall consistency of the measure with Article III. The Panel noted, on the other hand, that the United States argued that the key criterion in judging likeness under Article III was whether the measure was applied "so as to afford protection to domestic production".

5.6 The Panel observed that the ordinary meaning of the term "like" in paragraphs 2 and 4 of Article III was "the same" or "similar". The Panel recognized however that two individual products could never be exactly the same in all aspects. They could share common features, such as physical characteristics or end use, but would differ in others. These differences between products formed the basis of regulatory distinctions by governments which could result in less favourable treatment to imported products. Thus the practical interpretative issue under

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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?

5.7 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. The Panel noted that the purpose of Article III is set out in paragraph 1 of the article, which states:

> "The contracting parties 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.*" (emphasis added)

The Panel considered that paragraphs 2 and 4 of Article III had to be read in the light of this central purpose. The Panel reasoned therefore that Article III serves only to prohibit regulatory distinctions between products applied so as to afford protection to domestic production. Its purpose is not to prohibit fiscal and regulatory distinctions applied so as to achieve other policy goals. This view has been expressed in a recent panel report, which states:

> "The purpose of Article III is . . . not to prevent contracting parties from using their fiscal and regulatory powers for purposes other than to afford protection to domestic production. Specifically, the purpose of Article III is not to prevent contracting parties from differentiating between different product categories for policy purposes unrelated to the protection of domestic production. The Panel considered that the limited purpose of Article III has to be taken into account in interpreting the term "like products" in this Article. Consequently, in determining whether two products subject to different treatment are like products, it is necessary to consider whether such product differentiation is being made "so as to afford protection to domestic production".[128]

5.8 The Panel noted that earlier practice of the CONTRACTING PARTIES had been to determine the permissibility of regulatory distinctions under Article III on a case-by-case basis, examining likeness in terms of factors such as "the product's end-uses in a given market, consumers' tastes and habits, which change from country to country; the product's properties, nature and quality."[129] The Panel noted that regulatory distinctions based on such factors were often, but not always, the means of implementing government policies other than the protection of domestic industry. Non-protectionist government policies might, however, require regulatory distinctions that were not based on the product's end use, its physical characteristics, or the other factors mentioned. Noting that a primary purpose of the General Agreement was to lower barriers to trade between markets, and not to harmonize the regulatory treatment of products within them, the Panel considered that Article III could not be interpreted as prohibiting government policy options, based on products, that were not taken so as to afford protection to domestic production.

5.9 The Panel noted that the EC had relied in its interpretation of Article III:2 on the findings of an earlier panel. That panel had stated that:

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[128]Report of the Panel on *United States - Measures affecting alcoholic and malt beverages*, adopted 19 June 1992, DS23/R, BISD 39S/206

[129]Report of the Working Party on *Border Tax Adjustments,* adopted on 2 December 1970, BISD 18S/97, 102.

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> "the ordinary meaning of Article III:2 in its context and in the light of its object and purpose supported the past GATT practice of examining the conformity of internal taxes with Article III:2 by determining, firstly, whether the taxed imported and domestic products are "like" or "directly competitive or substitutable" and, secondly, whether the taxation is discriminatory (first sentence) or protective (second sentence of Article III:2).[130]

This two-step approach implied that less favourable tax treatment could not be imposed on a foreign product consistently with Article III:2 if the domestic and foreign products shared certain common features (likeness) and if the tax measure was discriminatory or protective. However, the first step of determining the relevant features common to the domestic and imported products (likeness) would in the view of the Panel, in all but the the most straightforward cases, have to include an examination of the aim and effect of the particular tax measure. Therefore the second step of determining whether the tax measure was discriminatory or protective was simply a continuation of the inquiry under the first step. The Panel concluded that its interpretation was consistent with previous ones, but made explicit that issues of likeness under Article III should be analyzed primarily in terms of whether less favourable treatment was based on a regulatory distinction taken so as to afford protection to domestic production.

5.10 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.[131] 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. A previous panel had stated:

> "Article III:2, first sentence, obliges contracting parties to establish certain competitive conditions for imported products in relation to domestic products. Unlike some other provisions in the General Agreement, it does not refer to trade effects."[132]

The Panel observed that the central objective of the analysis remained the determination of whether the regulatory distinction was made "so as to afford protection to domestic production." The analysis of aims and effects of the measure were elements that contributed to that determination.

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[130]Report of the Panel on *Japan - Customs duties, taxes and labelling practices on imported wines and alcoholic beverages*, adopted on 10 November 1987 (L/6216) BISD 34S/83 at 115, para. 5.5

[131]This term "shows the logical result or purpose of an action done in a specific manner" (Webster's Third New International Dictionary of the English Language (Unabridged)). This meaning is also reflected in the French authentic text of Article III:1 which uses the expression "de manière à".

[132]Report of the Panel on *United States - Taxes on petroleum and certain imported substances*, adopted 17 June 1987 (L/6175) BISD 34S/136 at 158, para 5.1.9; referring to the Report of the Working Party on *Brazilian Internal Taxes,* adopted on 30 June 1949, BISD II/181 at 185, para. 16; same view in Report of the Panel on *United States - Measures affecting alcoholic and malt beverages* adopted on 19 June 1992 (DS23/R) BISD 39S/206 at 271, para. 5.6

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(b) The luxury tax threshold

5.11 In the light of the preliminary considerations set out above, the Panel proceeded to examine whether it was consistent with Article III:2 for imported automobiles selling for more than $30,000 to be taxed more highly than domestic automobiles selling for less. This required the Panel to examine whether the threshold distinction was drawn so as to afford protection to domestic production.

5.12 The Panel first considered whether the *aim* of establishing the threshold within the luxury tax was to afford protection to domestic production. It noted that the EC had argued that evidence of statements by legislators suggested that the threshold was intentionally targeted on foreign automobiles. The Panel considered however that an assessment of the aim of the legislation could not be based solely on such statements or on other preparatory work. The aim of the legislation had also to be determined through the interpretation of the wording of the legislation as a whole. In the view of the Panel, the policy objective apparent in the legislation, to raise revenue from sales of perceived "luxury" products, was consistent with setting a price threshold, and setting it at a level at which only a small proportion of automobiles sold within the United States market were taxed. The fact that a large proportion of EC imports (but not necessarily a large proportion of imports from other countries) was affected by the measure did not demonstrate that the legislation was aimed at affording protection to domestic automobiles selling for less than $30,000. The Panel further noted that the conditions of competition accorded to products just above the $30,000 threshold did not differ markedly from those just below the threshold, and that there was considerable uncertainty as to the proportion of foreign and domestic automobiles selling above and below the threshold. This also suggested that the principal aim of the legislation was not to target closely a distinct product category of imported automobile.

5.13 The Panel then considered whether the threshold distinction in the luxury tax had the *effect*, in terms of conditions of competition, of affording protection to domestic production. The Panel noted that the parties submitted extensive data on sales of automobiles above and below the $30,0000 threshold. The data did not accord, due mainly to different assumptions regarding the actual transaction price at which the automobiles were sold. Just below the threshold, EC figures suggested that some 85 percent of automobiles sold in 1991 in the United States were domestic; the United States estimate was 42 percent. Just above the threshold, in the $30,000 to $33,000 range, the EC claimed that some 40 percent of automobiles sold in the United States in 1991 were domestic; the United States put the figure at 90 percent. The Panel noted that large numbers of cars of non-EC (mainly Japanese) origin were also sold at prices just below and just above the threshold level. The Panel did not find that the sales data provided conclusive evidence of a change in the conditions of competition favouring United States automobiles. Under either set of figures, the greater or lesser percentages could have been due to marketing and production decisions by EC manufacturers, by their United States or other foreign competitors, or by decisions of consumers in the market.

5.14 The Panel then considered whether there was evidence, other than sales or trade-flow data, that the threshold had the effect, in terms of conditions of competition, of affording protection to domestic automobiles. The Panel noted that a selling price above $30,000 did not appear from the evidence to be inherent to EC or other foreign automobiles. In particular, no evidence had been advanced that EC or other foreign automobile manufacturers did not in general have the design, production, and marketing capabilities to sell automobiles below the $30,000 threshold, or that they did not in general produce such models for other markets. On the contrary, there was evidence that EC automobile manufacturers produced a wide range of automobiles that, if exported to the United States, could sell for below $30,000. Some EC and many Japanese and other foreign models were in fact exported to the United States and sold for

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below $30,000. Nor had evidence been advanced that United States manufacturers did not have the capabilities to design, produce and market automobiles costing over $30,000. The Panel also noted that there was no sudden transition to a higher tax at the threshold. The more closely automobiles above and below the threshold competed on price, the less the tax affected their competitiveness. These factors, together with the fact that the threshold did not appear arbitrary or contrived in the context of the policies pursued, indicated to the Panel that in this case, the dominant presence at a particular time of the EC cars in the sector of the market affected by the measure could not be taken as evidence of a discriminatory effect. In the view of the Panel therefore the regulatory distinction of $30,000 did not create conditions of competition that divided the products inherently into two classes, one of EC or other foreign origin and the other of domestic origin.

5.15 The Panel concluded that the threshold distinction of $30,000 in the luxury tax was not implemented so as to afford protection to the domestic production of automobiles, that automobiles above and below that threshold value could not, for the purposes of the luxury tax, be considered as like products under Article III:2, first sentence, and that different treatment could therefore be accorded under the luxury tax to automobiles above and below the threshold.

(ii) Article III:2, second sentence

5.16 The Panel then proceeded to examine the EC contention that the regulatory distinctions made in connection with the luxury tax were also inconsistent with Article III:2, second sentence, which states:

> "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."

The Panel noted that the effect of Article III:2, second sentence, is to extend the scope of the national treatment obligation from "like" products to "directly competitive or substitutable" products, in cases where the measure is applied "so as to afford protection to domestic production." Having found in its examination under Article III:2, first sentence, of the products subject to the luxury tax that the measure was not applied so as to afford protection, the Panel concluded that the measure at issue was consistent also with the Article III:2, second sentence.

B. Gas Guzzler Tax

5.17 The Panel noted that the issues in dispute with respect to the gas guzzler tax arose essentially from the following facts, as described more fully in Part II of this report. The United States imposes a tax on the sale by the manufacturer (including the importer) of each automobile of a model type that has low fuel economy.[133] For model types achieving 22.5 mpg or more, no tax is payable. For model types between 22.5 mpg and 12.5 mpg, the tax payable varies from $1,000 to $6,400, based on ten steps. For model types below 12.5 mpg, a tax of $7,700 is payable. The legislation covers automobiles, which are defined as a four-wheeled vehicles, propelled by fuel, generally weighing 6,000 pounds or less, and manufactured primarily for use on public streets, roads, and highways. It does not cover prescribed "non-passenger" automobiles, such as light trucks and emergency vehicles.

[133] Energy Tax Act of 1978, 26 U.S.C. 4064 et seq.

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5.18 The gas guzzler tax on a particular automobile is based on the calculated fuel economy of its model type. The "model type" includes all automobiles which share major design characteristics that both influence fuel economy and are easily recognizable by consumers. The fuel economy of a model type is calculated by testing different versions of it that contain minor differences in design characteristics that may influence fuel economy, and averaging the results on a sales-weighted basis. The model type fuel economy figure is determined, for the purpose of the gas guzzler tax, on the fuel economy figures of relatively few actual tests, since the fuel economy figures must be available at the start of the model year.

5.19 The Panel then considered the main arguments of the parties. It noted the view of the EC that the gas guzzler tax imposed by the United States on the sale of automobiles with a fuel economy of less than 22.5 mpg was inconsistent with Article III:2, first sentence. According to the EC all automobiles were like products, because of their common physical characteristics, components and end-use. A difference in fuel economy was not sufficient to make one automobile unlike another for the purposes of Article III:2. Since most automobiles subject to the tax were of EC origin, and very few were of United States origin, treatment under the measure was discriminatory. The EC claimed that the disproportionate impact was directly attributable to the application of the gas guzzler tax, and not to marketing and production decisions by EC manufacturers and importers. The measure effectively targeted EC automobiles, and was not based on the application of objective policy criteria or a trade-neutral system of taxation. The exclusion of light trucks, including minivans, from the tax exacerbated the disproportionate impact of the tax. As well, the EC argued that since only a very small proportion of automobiles in the United States market were subject to the tax, the measure was effective neither in raising revenue nor in conserving fuel.

5.20 The Panel noted also the view of the United States that the gas guzzler tax was not inconsistent with Article III:2, first sentence. The United States argued that under Article III:2 a regulatory distinction could legitimately be made between any two products, as long as the distinction was based on objective criteria aimed at a policy other than the protection of domestic production. The distinction drawn in the gas guzzler law between automobiles above and below the 22.5 mpg threshold was justifiable in these terms. The tax was gradual, had reasonable thresholds, and complemented the effects of the CAFE regulations. The United States further argued that the impact of the measure in terms of volume, value and proportion of trade was not relevant. Article III did not protect actual trade flows, but expectations on conditions of competition resulting from government measures. The United States finally argued that, should the gas guzzler tax be found inconsistent with Article III:2, it could be justified under Article XX(g) as a measure related to the conservation of fossil fuels, an exhaustible natural resource.

(i) Article III:2, first sentence

5.21 The Panel proceeded to examine the argument by the EC that the gas guzzler tax imposed by the United States on the sale of foreign and domestic automobiles with a fuel economy of less than 22.5 mpg was inconsistent with Article III:2, first sentence.

5.22 The Panel considered first whether the gas guzzler taxes were "internal taxes or other internal charges of any kind" referred to in Article III:2. It noted that the gas guzzler tax was imposed "on the sale by the manufacturer of each automobile", and that a manufacturer was defined for the purposes of the tax as including an automobile producer or importer. All sales of automobiles within the United States were therefore within the scope of the provision. The Panel accordingly found, consistently with the views of the parties, that the gas guzzler tax was an internal tax or charge of the type covered by Article III:2.

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5.23 The Panel then recalled its previous discussion of the nature of the obligation under Article III (see paras. 5.5 - 5.10), and its conclusion that in determining whether an imported product has been accorded treatment less favourable than the like domestic product, the main criterion was whether the distinctions justifying the different treatment were drawn "so as to afford protection" to domestic production. It was therefore necessary first to identify the particular regulatory distinctions drawn between imported automobiles subject to the tax and domestic automobiles that were not. The Panel noted that regulatory distinctions arose under the gas guzzler tax between an imported automobile of a model type below 22.5 mpg and:

a) any domestic automobile of a model type above 22.5 mpg;

b) some domestic automobiles with the same tested fuel economy as the imported automobile, but placed in a model type having higher fuel economy because of averaging with more economical variants within that model type

c) any domestic vehicle, including a light truck, not covered by the measure.

The Panel decided to examine successively each of these resulting regulatory distinctions in order to determine whether they were applied so as to afford protection to domestic production, resulting in the products so distinguished being considered as like products for the purposes of Article III:2.

(a) Domestic automobiles above the threshold

5.24 The Panel noted that the gas guzzler tax was triggered by a fuel economy threshold of 22.5 mpg. Automobiles with a fuel economy above that figure did not pay any gas guzzler tax. The Panel first examined whether this threshold distinction was *aimed* at affording protection to domestic production. The EC argued that the United States measure targeted EC automobiles, and was therefore aimed at protecting domestic production. The United States argued that the threshold distinction in the gas guzzler tax was aimed at a policy goal other than the protection of domestic production. The United States stated that the overall purpose of the gas guzzler tax was to conserve fossil fuels, and that the threshold ensured that only the most uneconomical automobiles were subject to the tax. It had been designed to cover only some automobiles because it was complementary to the CAFE regulation. The EC replied that the overall aim of the measure could not be fulfilled, since the few cars affected by the measure could have only a very small effect on the overall consumption of fossil fuels in the United States. The Panel observed that the threshold in the gas guzzler tax created an incentive in the United States market to purchase more fuel-efficient automobiles, and that this incentive would normally lead to increased conservation of fossil fuels. Although the overall economic efficiency of the measure with respect to the reduction of fuel consumption might be questioned when compared to, for example, a fuel tax, the Panel did not consider that this factor was by itself relevant in determining obligations under Article III. The Panel also noted that when the gas guzzler tax was introduced in 1978, most domestic automobiles could not achieve the final threshold figure set out in the legislation. This was a further indication to the Panel that the gas guzzler threshold figure did not target foreign automobiles.

5.25 The Panel then examined whether the *effect* of the threshold, in terms of conditions of competition, was to afford protection to domestic production. The Panel noted that the parties had submitted extensive sales and trade-flow data on automobiles subject to the gas guzzler tax. However, the Panel did not consider that these figures in themselves could provide evidence of a change in conditions of competition favouring domestic automobiles. The Panel further noted that the nature and level of the regulatory distinction made at the threshold of the gas guzzler

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measure were consistent with the overall purpose of the measure and did not appear to create categories of automobiles of inherently foreign or domestic origin. The technology to manufacture high fuel economy automobiles - above the 22.5 mpg threshold - was not inherent to the United States, nor were low fuel economy automobiles inherently of foreign origin, as the Panel noted from fuel economy figures submitted by the parties. Thus the fact that EC automobiles bore most of the burden of the tax did not mean that the measure had the effect of affording protection to United States production. The Panel also noted that the amount of the tax payable at the threshold did not seem excessive, given the range and progression of the tax. The Panel found therefore that the threshold distinction created under the gas guzzler law did not have the effect of affording protection to domestic production.

5.26 The Panel found therefore that the application of the threshold distinction did not result in a change in the conditions of competition that afforded protection to the production of automobiles in the United States. In terms of Article III:2, and for the purposes of the gas guzzler tax, foreign automobiles below the 22.5 mpg threshold were not "like" domestic automobiles above the threshold, and different and less favourable treatment under the gas guzzler measure could therefore be accorded to them.

(b) Domestic automobiles with a higher computed fuel economy

5.27 The Panel then considered whether the regulatory distinctions allowing domestic automobiles with the same tested fuel economy as imported automobiles to obtain a better computed fuel economy, through averaging with more economical configurations, could justify under Article III:2 taxes higher on imported than on domestic automobiles. According to the EC, the possibility of such averaging benefitted automobile manufacturers which, like those in the United States, produced models in many different configurations. The United States disagreed, providing evidence that most automobile manufacturers, domestic and foreign, could and did benefit from the averaging methods used in the gas guzzler law.

5.28 The Panel observed that sampling methods used for the purpose of determining the characteristics of individual products were commonly used by contracting parties. Where the costs were high of measuring the characteristics of a product existing in large quantities, in many similar but distinct versions, or divided into multiple shipments, sampling was often the only practical way of applying regulations. The Panel recognized that cases could arise under the gas guzzler measure where two individual automobiles with the same tested fuel economy would, because of averaging between different configurations, be attributed different computed fuel economies. However, the Panel observed that this sampling difference was not arbitrary: because of sales-weighting, the methodology ensured in general that the computed fuel economy figure used for determining the tax on an individual automobile represented the tested figure of the most common configuration sold. Since all individual automobiles of the same model type (and thus with the same computed fuel economy) shared the same major design characteristics affecting fuel economy, the scope for large differences in fuel economy between individual automobiles of the same model type was limited. The fuel economy calculation under the gas guzzler regulations thus represented a sampling methodology related to the characteristics of the individual product and close variations of this product.

5.29 The Panel then examined whether the *aim* of the distinctions made in the gas guzzler fuel economy calculations was to afford protection to domestic production. The Panel noted that the United States had advanced policy reasons to justify the regulatory distinctions made in the gas guzzler methodology: the need to obtain figures for individual automobiles before the beginning of the model year meant that sampling on the basis of a limited number of tests weighted by sales projections was necessary to obtain both accuracy and efficiency. The Panel considered that these

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reasons were consistent with the overall policy goal of conserving fuel and therefore found that the regulatory distinctions drawn in the calculation of the gas guzzler tax did not have the aim of affording protection to domestic production.

5.30 The Panel then examined whether the distinctions drawn in the calculation of fuel economy for the purposes of the gas guzzler regulation had the *effect,* in terms of conditions of competition, of affording protection to domestic production. The Panel noted that the existence of many variations of a given model type could give rise to differences in tested and final fuel economy figures. However, it noted that the final figure had to be the tested figures of the highest-selling model type variations, which limited the possibility of manipulating the averaging. The Panel also noted that averaging could work both ways - model type variations with better than the computed average would have their tested figure reduced to that computed figure. The Panel was therefore not convinced that the fuel economy averaging method established conditions of competition more favourable to automobile models with many variations. It was also not convinced that a limited range of model variations was inherent to automobiles of foreign origin.

5.31 The Panel then noted that the gas guzzler regulations gave a manufacturer the *option* of providing additional data on other versions. This, in the view of the Panel, provided an advantage to manufacturers producing different versions of the same automobile, since only they were in a position to exercise some choice as to how the fuel economy figure would be computed. If the version improved the sales-weighted average fuel economy figure, it could be included, if not it could be disregarded. However as noted above, the Panel was not convinced that the existence of many versions of a given automobile model type was an inherent characteristic of domestic automobiles, or that the existence of only a few or no versions was an inherent characteristic of automobiles of foreign origin. Such an advantage would not, therefore, alter the conditions of competition in favour of the domestic automobile, and thereby have the effect of affording protection to domestic production. The Panel therefore found that the distinctions drawn in the gas guzzler calculation methods did not have the effect of affording protection to domestic production.

5.32 The Panel found therefore that the regulatory distinctions made in the calculation of the fuel economy of individual models under the gas guzzler law and regulations did not result in a change in the conditions of competition that afforded protection to the production of automobiles in the United States. In terms of Article III:2, and for the purpose of the gas guzzler tax, an individual imported automobile whose model type fuel economy was less than 22.5 mpg was not "like" an individual domestic automobile whose model type fuel economy was above 22.5 mpg, even if the fuel economy of the individual domestic automobile was below 22.5 mpg. Therefore, in such cases, different and less favourable treatment under the gas guzzler measure could be accorded to the imported automobile.

(c) Domestic vehicles not covered by the measure

5.33 The Panel then considered whether the exclusion from the gas guzzler measure of other fuel-consuming vehicles, in particular light trucks, was applied so as to afford protection to domestic production.[134] The Panel first examined whether the measure had the *aim* of affording protection to domestic production. It noted that the United States had advanced a policy goal other than the protection of domestic production to justify the distinction made with respect to light trucks: the United States did not wish to tax, on the basis of fuel economy, vehicles which for technical reasons owing to their commercial or utilitarian use had relatively lower fuel economy. The Panel recognized that a measure covering all, rather than just some, vehicles

[134]Internal Revenue Code §4064(b)(1)(B)

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would likely achieve more fully the objective of conserving fuel. In particular, the Panel noted that light truck (including sports utility vehicle) sales in the United States were a significant part of total United States vehicle sales, and that many light trucks were used for the same purposes as normal passenger automobiles. However, in the view of the Panel, the efficiency of the measure was not by itself relevant in assessing its conformity under Article III.

5.34 The Panel then examined whether the exclusion of vehicles other than automobiles had the *effect,* with respect to the conditions of competition, of affording protection to domestic production. In the Panel's view, it had not been shown that automobiles as a product defined in the measure were inherently of foreign origin, or that other vehicles consuming fossil fuels were inherently of domestic origin. In particular, it had not been shown that light trucks as defined in the gas guzzler measure were inherently of domestic origin. The Panel noted that such products were in fact common within the model ranges of foreign producers. The gas guzzler measure could therefore not be said to have had the effect of modifying the conditions of competition between foreign and domestic products.

5.35 The Panel found therefore that by limiting the gas guzzler tax to automobiles as defined in the measure, the United States did not afford protection to domestic production of automobiles in the United States. In terms of Article III:2, and for the purposes of the gas guzzler tax, imported automobiles were not "like" domestic light trucks, and different and less favourable treatment under the gas guzzler measure could therefore be accorded to them.

5.36 Accordingly, the Panel concluded that the regulatory distinctions examined in the gas guzzler regulation were not applied so as to afford protection to domestic production, and thus did not distinguish between like products. The taxes under the gas guzzler measure could therefore be applied to imported automobiles in conformity with Article III:2, first sentence, on the basis of the examined regulatory distinctions.

(ii) Article III:2, second sentence

5.37 The Panel then proceeded to examine the conformity of the gas guzzler measure with Article III:2, second sentence. The Panel noted its earlier analysis, in which it reasoned that Article III:2 applies only in cases where a measure is applied "so as to afford protection to domestic production." Having found that the measures examined under the gas guzzler tax were not so applied, the Panel concluded that the measures at issue were consistent also with Article III:2, second sentence.

(iii) Article XX(g)

5.38 Having found that the gas guzzler tax was not inconsistent with Article III:2 and III:4 of the General Agreement, the Panel concluded also that it was not necessary to examine whether the measure was justified under the provisions of Article XX(g) on the conservation of exhaustible natural resources.

C. Corporate Average Fuel Economy (CAFE) Regulation

5.39 The Panel noted that the issues in dispute with respect to the Corporate Average Fuel Economy (CAFE) regulation arose essentially from the following facts, as described more fully in Part II of this report. The United States maintains a measure requiring that the average fuel economy for passenger automobiles manufactured by any manufacturer not fall below a certain level. A manufacturer is deemed to be any person engaged in the business of producing or

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assembling automobiles in the customs territory of the United States, or importing them.[135] Automobiles manufactured by a manufacturer are deemed to include all automobiles manufactured by persons who control, are controlled by, or are under common control with, the manufacturer, less those automobiles that are exported.[136] The current average fuel economy level is set at 27.5 mpg. Failure to attain this figure is unlawful and results in a civil penalty of $5 for every tenth of a mile per gallon that the fleet average is below 27.5 mpg, multiplied by the number of automobiles in the manufacturer's fleet.[137] This level applies only to passenger automobiles, defined as automobiles manufactured primarily for use in the transportation of not more than ten individuals, but not those capable of off-highway operation, such as light trucks. [138] For non-passenger automobiles, the United States sets different average fuel economy standards.[139] Manufacturers whose world-wide production is fewer than 10,000 automobiles may on request be exempted from the normal average fuel economy standards.[140] A manufacturer must meet average fuel economy standards for both its imported and domestic fleets, calculated separately.[141] An automobile is considered part of the domestic fleet if less than 25 percent of its value is imported.[142]

5.40 The calculation of the fleet average fuel economy under the CAFE regulations is derived from the fuel economy of each automobile's model type.[143] The model type includes all passenger automobiles which share major design characteristics that both influence fuel economy and are easily recognizable by consumers. As under the gas guzzler tax, the fuel economy of a model type is computed by testing different versions of it containing minor differences in design characteristics that may influence fuel economy. Unlike the gas guzzler tax, the CAFE regulations require that at least 90 percent of the model type configurations be tested.[144] The CAFE figure is calculated through averaging the model type fuel economy figures of all the automobiles produced or imported for the model year by the manufacturer or importer. Credits for fleet averages exceeding 27.5 mpg can be carried backward or forward three years.[145]

5.41 For the purposes of its examination the Panel decided to refer to automobiles as cars, and to refer to those achieving at least 27.5 mpg as "small cars" and others as "large cars". The Panel then turned to the arguments of the parties. It noted the view of the EC that the CAFE regulations imposed by the United States on car importers violated paragraphs 2 and 4 of Article III. According to the EC, treatment based on fleet averaging was inherently discriminatory, since importers of cars from specialized manufacturers, which tended to be foreign, could not offset the fuel economy of cars below the standard with those above the standard. The regulation had a disproportionate impact on EC cars, influenced further by the lower standard provided for the light truck category. The United States disagreed with the EC. It argued that the CAFE regulation, a requirement in the meaning of Article III:4 and not a tax under Article III:2, provided equal treatment to all manufacturers and importers, and did not afford protection to domestic production. An analysis of resulting trade-flows was not relevant to the application of Article III, and in any case did not show any disproportionate impact on cars of EC or other foreign origin.

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[135]Energy Policy and Conservation Act, 15 U.S.C. §2001 (8), (9)
[136]*Id* at §2003(c)
[137]*Id* at §2007, §2008
[138]*Id* at §2001(2)
[139]*Id* at §2002(b)
[140]*Id* at §2002(c)(1)
[141]*Id* at §2003(b)(1)
[142]40 C.F.R. Ch. 1 §600.511-80
[143]*Id* at §2003(a)(1)
[144]40 C.F.R. Ch 1 §600.010-86(d)
[145]*Id* at §2002(l)(1)(A)

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(i) Article III

5.42 The Panel proceeded first to examine whether the CAFE measure should be considered within the category of "internal taxes or other internal charges" under Article III:2, or within the category of "laws, regulations and requirements" under Article III:4. The EC claimed that the CAFE measure was a tax within the scope of Article III:2. It argued that the amount of the payment under the measure was based on a precise count of cars manufactured or imported into the United States, and that the measure was therefore equivalent to a tax. The EC claimed that if such measures were not considered to be taxes on products but laws, regulations or requirements, then contracting parties could easily circumvent the national treatment principle in Article III by converting product taxes into year-end penalty payments. The United States disagreed, claiming that the CAFE measure was a requirement within the scope of Article III:4 enforced by penalty payments, and not a tax under Article III:2. It argued that the penalties were not taxes since they were not deductible against income taxes, were not assessed against particular vehicles or against particular consumers of cars, and were not assessed until at least a year after the relevant model year. It further argued that the correlation between the CAFE payment and the number of cars in the fleet and their fuel characteristics did not disqualify the payment as a penalty.

5.43 The Panel then examined the text of the CAFE measure, which states that "the following conduct is unlawful: . . . the failure of any manufacturer to comply with any average fuel economy standard applicable to such manufacturer."[146] It further provides for civil penalties if average fuel economy requirements are not met: "[A]ny manufacturer whom the Secretary determines . . . to have violated a provision . . . of this title with respect to any model year, shall be liable to the United States for a civil penalty . . .".[147] The Panel observed first that the United States had asserted that the CAFE regulations imposed a requirement enforced by penalties. The Panel then noted that this interpretation corresponded to the ordinary meaning of the terms used in the regulation. The fact that the economic effects of the CAFE penalties might in some respects be similar to those of a tax did not allow the conclusion that the CAFE measure was an internal tax or other internal charge within the meaning of Article III:2. The Panel therefore concluded that the EC had not demonstrated that the CAFE measure was an internal tax or other internal charge within the meaning of Article III:2.

(ii) Article III:4

5.44 The Panel proceeded therefore to examine the CAFE requirement in the light of Article III:4. This provision states in part:

> "The products of the territory of any contracting party imported into the territory of any other contracting party shall be accorded treatment no less favourable than that accorded to like products of national origin in respect of all laws, regulations and requirements affecting their internal sale, offering for sale, purchase, transportation, distribution or use."

5.45 The Panel considered first whether in terms of Article III:4 the CAFE measure was a requirement "affecting" the internal sale, offering for sale, purchase, transportation, distribution or use of a product. The Panel noted that for a measure to be subject to Article III, it does not have to regulate a product directly. It only has to affect the conditions of competition between domestic and imported products. A previous panel had explained this principle:

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[146] *Id* at §2007

[147] *Id* at §2008(b)(1)(A)

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> "In addition, the text of paragraph 4 referred both in English and French to laws and regulations and requirements *affecting* internal sale, purchase, etc., and not to laws, regulations and requirements governing the conditions of sale or purchase. The selection of the word "affecting" would imply, in the opinion of the Panel, that the drafters of the Article intended to cover in paragraph 4 not only the laws and regulations which directly governed the conditions of sale or purchase but also any laws or regulations which might adversely modify the conditions of competition between the domestic and imported products on the internal market."[148]

The Panel observed that the CAFE measure was not applied to cars as such, but that it regulated the conduct of manufacturers and importers. The Panel therefore examined whether regulations applied to manufacturers of cars, and not directly to cars, could "affect" the product in terms of Article III:4. As previously noted by the Panel, the purpose of Article III is to ensure that imported products benefit from conditions of competition no less favourable than like domestic products. Since conditions of competition could easily be modified by regulations applied directly to producers or importers and not to a product, the Panel considered that the direct application of a regulation to a producer did not mean that the regulation could not "affect" the conditions of competition of the product. A previous panel had applied this principle and stated:

> "Nor could the applicability of Article III:4 be denied on the ground that most of the procedures in the case before the Panel are applied to persons rather than products, since the factor determining whether persons might be susceptible to Section 337 proceedings or federal district court procedures is the source of the challenged products, that is whether they are of United States origin or imported."[149]

5.46 The Panel agreed with this reasoning and consequently examined whether the source of the cars, that is whether they are of United States origin or imported, is among the factors that determine whether the manufacturer concerned complies with the CAFE requirement and whether any distinctions as to the source of the cars accorded to imported cars conditions of competition less favourable than those accorded to domestic cars. The Panel noted that the treatment of a particular car under the CAFE regulation depended on factors including: (a) the domestic or foreign source of the cars, which determined which fleet, domestic or foreign, they entered into, and (b) the control and ownership relationships of the producer/importer, which determined the size and composition of the fleet within which the cars were averaged.

(a) Separate foreign fleet accounting

5.47 The Panel recalled that under the CAFE measure a manufacturer is required to obtain a figure of at least 27.5 mpg for both its domestic and imported fleets. Cars wholly produced in the United States (or Canada), or of which the value added in the United States (or Canada) is at least 75 percent, are counted in the domestic fleet; all others are counted in the imported fleet. The Panel noted that separate foreign fleet accounting prevented manufacturers of large domestic cars from meeting the CAFE requirement for their domestic fleet by adding to it small foreign cars, or small cars made from foreign parts. In such cases the CAFE measure placed small foreign cars and foreign parts in a less favourable competitive position with respect to small domestic cars and

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[148]Report of the Panel on *Italian Discrimination against imported agricultural machinery*, adopted 23 October 1958, BISD 7S/60, 64 at para. 12

[149]Report of the Panel on *United States - Section 337 of the Tariff Act of 1930*, adopted 7 November 1989, BISD 36S/345, para. 5.10

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domestic parts. The Panel also noted that the CAFE measure prevented manufacturers of large foreign, but not domestic, cars from meeting their CAFE requirements for their imported fleet by adding to it small domestic cars. In such cases the CAFE measure also placed large foreign cars in a less favourable competitive position with respect to large domestic cars. The Panel therefore found that the requirement of separate foreign fleet accounting under the CAFE regulation accorded to particular products of foreign origin conditions of competition less favourable than those accorded to like domestic products.

5.48 The Panel then examined whether under Article III less favourable treatment of imported products in some circumstances could be balanced by less favourable treatment of domestic products in other circumstances. In this case, less favourable treatment of large foreign cars (because they could not be averaged with small domestic cars, as large domestic cars could) would be balanced by less favourable treatment of large domestic cars (because they could not be averaged with small foreign cars, as large foreign cars could). The Panel noted that under Article III:4 a contracting party cannot justify less favourable treatment to an individual product by showing that other products receive more favourable treatment. A previous panel had explained the basis of this principle:

> "The Panel further found that the "no less favourable" treatment requirement of Article III:4 has to be understood as applicable to each individual case of imported products. The Panel rejected any notion of balancing more favourable treatment of some imported products against less favourable treatment of other imported products. If this notion were accepted, it would entitle a contracting party to derogate from the no less favourable treatment obligation in one case, or indeed in respect of one contracting party, on the ground that it accords more favourable treatment in some other case, or to another contracting party. Such an interpretation would lead to great uncertainty about the conditions of competition between imported and domestic products and thus defeat the purposes of Article III."

5.49 The Panel agreed with this reasoning and concluded that the separate foreign fleet accounting accorded less favourable conditions of competition to cars and car parts of foreign origin than those accorded to like domestic products, and was thus inconsistent with Article III:4.

(b) Fleet averaging

5.50 The Panel then noted the argument of the EC that, because the CAFE regulation placed only full-line manufacturers in a position to sales-average large cars with small cars within the same fleet to attain the required 27.5 mpg standard, EC limited-line car manufacturers were prejudiced under Article III:4. The United States replied that the CAFE measure applied equally to cars of all origins and was thus consistent with Article III:4. The Panel noted that the averaging methodology in the CAFE regulation meant that large cars could in some circumstances be combined with small cars in order to meet the CAFE requirement. In other circumstances, like large cars could not be combined with small cars. Thus an imported large car which could not be combined with a small car would be treated less favourably than a like domestic large car which could be so combined. The Panel noted that the difference in treatment under the averaging methodology depended on several factors not directly relating to the product as a product, including the relationship of ownership and control of the manufacturer/importer. The Panel decided to examine fleet averaging first in the light of this distinction.

5.51 The Panel proceeded to examine the argument of the United States that the CAFE regulation provided all manufacturers or importers with the same flexibility in meeting its

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requirements, and that imported cars were consequently accorded treatment no less favourable than domestic cars. This raised in the view of the Panel the question of whether Article III permitted the application to imported products of measures applied to domestic products that differentiated between them on the basis of the ownership or control of the manufacturers or importers, since this was the element that defined the scope of the products to be averaged under fleet averaging requirement.

5.52 The Panel examined this issue in the light of the text of Article III. It observed that Article III prescribes in general the treatment to be accorded to imported *products* in relation to domestic products. In particular, Article III:1, which sets out the principle underlying Article III, refers to treatment resulting from measures applied to products. Article III:4 refers only to laws, regulations and requirements affecting the internal sale, offering for sale, purchase, transportation, distribution or use of products. The Panel noted that these activities relate to the product *as a product*, from its introduction into the market to its final consumption. They do not relate directly to the producer. The Panel further noted that a similar principle underlies the treatment of taxes under Art. III:2. A Working Party report had interpreted this provision as permitting domestic taxes to be applied to foreign products (ie. border adjusted) only when the taxes were "directly levied on products":

> "[T]here was a convergence of views to the effect that taxes directly levied on products were eligible for tax adjustment. Examples of such taxes comprised specific excise duties, sales taxes and cascade taxes and the tax on value added … Furthermore, the Working Party concluded that there was convergence of views to the effect that certain taxes that were not directly levied on products were not eligible for adjustment. Examples of such taxes were social security charges whether on employers or employees and payroll taxes."[150]

The Panel noted that the domestic taxes mentioned in the Working Party report that could be applied also to foreign products (ie. border adjusted) were based on factors directly related to the product, for example its sale within the importing country. Those that could not be so applied were not directly related to the product, but to other factors such as the income of the producer.

5.53 The Panel considered that this limitation on the range of domestic policy measures that may be applied also to imported products reflected one of the central purposes of Article III: to ensure the security of tariff bindings. Contracting parties could not be expected to negotiate tariff commitments if these could be frustrated through the application of measures affecting imported products subject to tariff commitments and triggered by factors unrelated to the products as such. If it were permissible to justify under Article III less favourable treatment to an imported product on the basis of factors not related to the product as such, Article III would not serve its intended purpose. Equally important, the right to unconditional most-favoured nation treatment in the application of Article III:4, which is specifically mentioned in Article I:1, would not be assured.

5.54 These considerations confirmed in the view of the Panel that Article III:4 does not permit treatment of an imported product less favourable than that accorded to a like domestic product, based on factors not directly relating to the product as such. The Panel found therefore that, to the extent that treatment under the CAFE measure was based on factors relating to the control or ownership of producers/importers, it could not in accordance with Article III:4 be applied in a manner that also accorded less favourable treatment to products of foreign origin. It was therefore not necessary to examine whether treatment based on these factors was also applied so as to afford protection to domestic production.

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[150]Report of the Working Party on *Border Tax Adjustments,* adopted on 2 December 1970, BISD 18S/97.

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5.55 The Panel concluded that the fleet averaging requirement based on the ownership or control relationship of the car manufacturer did not relate to cars as products. This requirement could thus result in treatment less favourable than that accorded to like domestic products. Therefore it could not be imposed consistently with Article III:4 so as to affect also cars of foreign origin.

(iii) Article XX(g)

5.56 The Panel noted the view of the United States that even if the provisions under the CAFE regulation were contrary to Article III:4 they could be justified under the terms of Article XX(g) relating to the conservation of exhaustible natural resources. The EC argued that the measure did not meet the requirements of Article XX(g). The Panel then examined the terms of Article XX(g):

> "Subject to the requirement that such measures are not applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where the same conditions prevail, or a disguised restriction on international trade, nothing in this Agreement shall be construed to prevent the adoption or enforcement by any contracting party of measures:
> …
> (*g*) relating to the conservation of exhaustible natural resources if such measures are made effective in conjunction with restrictions on domestic production or consumption;"

The Panel observed that the text of Article XX(g) suggested a three-step analysis:

— First, it had to be determined whether the *policy* in respect of which these provisions were invoked fell within the range of policies to conserve exhaustible natural resources.

— Second, it had to be determined whether the *measure* for which the exception was being invoked - that is the particular trade measure inconsistent with the obligations under the General Agreement - was "related to" the conservation of exhaustible natural resources, and whether it was made effective "in conjunction" with restrictions on domestic production or consumption.

— Third, it had to be determined whether the measure was applied in conformity with the requirements set out in the introductory clause to Article XX, that the measure not be applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where the same conditions prevail or in a manner which would constitute a disguised restriction on international trade.

5.57 The Panel considered first the issue of whether the *policy* in respect of which the CAFE measure was invoked was a policy to conserve an exhaustible natural resource. The Panel, noting that gasoline was produced from petroleum, an exhaustible natural resource, found that a policy to conserve gasoline was within the range of policies mentioned in Article XX(g).

5.58 The Panel then turned to the issue of whether the *measure* for which the exception was being invoked (the particular CAFE measure inconsistent with the obligations under the General Agreement) was "related to" the policy of conserving gasoline, and whether it was made effective "in conjunction" with restrictions on domestic production or consumption of gasoline. The Panel

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noted that the United States argued that the measure did not have to be "necessary", but merely "primarily aimed at", the conservation of an exhaustible natural resource. The United States further claimed that the measure had in fact conserved fuel, and that such results could not have occurred without the measure. Since the transportation sector in the United States consumed a disproportionate amount of fuel compared to other countries, a measure in respect of cars was of particular importance in conserving fuel. In the view of the United States, the fact that the measure acted indirectly to restrict the sale of cars with high fuel consumption rather than directly to restrict the sale of fuel was not relevant. Taxing of fuel would be regressive and would not promote technological innovation. The EC argued that the averaging scheme did not advance, and in some ways undermined, the objective of fuel conservation; a manufacturer could sell many large cars without penalty as long as it sold also small cars. It also argued that the CAFE measure restricted a secondary product (cars) instead of directly regulating consumption of the resource (gasoline). The measure did not create a disincentive to driving a car for longer distances or in a fuel-inefficient manner.

5.59 The Panel observed that a measure inconsistent with a provision of the General Agreement but justified under Article XX(g) had to be a measure "relating to" the conservation of exhaustible natural resources, and be adopted "in conjunction with" restrictions on domestic production or consumption. The Panel noted that a previous panel had examined these notions in Article XX(g) in the following terms:

> "[A]s the preamble of Article XX indicates, the purpose of including Article XX(g) in the General Agreement was not to widen the scope for measures serving trade policy purposes but merely to ensure that the commitments under the General Agreement do not hinder the pursuit of policies aimed at the conservation of exhaustive natural resources. The Panel concluded for these reasons that, while a trade measure did not have to be necessary or essential to the conservation of an exhaustible natural resource, it had to be primarily aimed at the conservation of an exhaustible natural resource to be considered as "relating to" conservation within the meaning of Article XX(g). The Panel, similarly, considered that the terms 'in conjunction with' in Article XX(g) had to be interpreted in a way that ensures that the scope of possible actions under that provision corresponds to the purpose for which it was included in the General Agreement. A trade measure could therefore in the view of the Panel only be considered to be made effective 'in conjunction with' production restrictions if it was primarily aimed at rendering effective these restrictions."[151]

The Panel proceeded to examine whether the measure was primarily aimed at fuel conservation, and at rendering effective domestic production restrictions. It recalled that the measure requiring justification under Article XX(g) was not the Motor Vehicle Information and Cost Saving Act in general, nor the establishment of the CAFE fuel consumption standard as such. The measure at issue was the discrimination against foreign cars and parts resulting from the CAFE regulations providing for the calculation of the fleet average fuel consumption. The Panel decided to examine successively the justification of the measure with respect to the separate foreign fleet accounting requirement, and to the averaging method based on the relationship of ownership and control of the producer or importer.

[151]Report of the Panel in *Canada - Measures affecting exports of unprocessed herring and salmon* , L/6268, adopted 22 March 1988, 35S/98, 114, para 4.6

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(a) Separate foreign fleet accounting

5.60 The Panel noted that the United States had provided the Panel with extensive explanations of the environmental objectives of the Motor Vehicle Information and Cost Savings Act and the CAFE standard, but that it had provided no evidence that the exclusion of averaging large imported cars with small cars produced in the United States and under the same ownership or control of production furthered these objectives. In fact, the evidence submitted to the Panel suggested that separate foreign fleet accounting primarily served to inhibit imports of small cars. This did not contribute directly to fuel conservation in the United States. Indeed, it was likely to make it more costly, and therefore more difficult, for domestic manufacturers to meet the CAFE standard and the overall goal of conserving fuel. The Panel was of the view that a measure that did not further the objectives of conservation of an exhaustible resource could not be deemed to be primarily aimed at such conservation and therefore found that the measure found to be inconsistent with Article III:4 was not justified by Article XX (g).

5.61 The Panel therefore concluded that less favourable treatment, in terms of conditions of competition, accorded to large imported cars due to separate foreign fleet accounting and inconsistent with Article III:4 was not primarily aimed at the conservation of natural resources and therefore could not be justified by Article XX(g). It was therefore not necessary to examine whether separate foreign fleet accounting also met the requirement of being primarily aimed at rendering effective the restrictions imposed on domestic production, and whether it met the requirements of the introductory clause of Article XX.

(b) Fleet averaging

5.62 The Panel then examined whether the inconsistency with Article III:4, which results from the differential treatment of cars according to ownership or control relationships of the producer or importer, could be justified under Article XX(g). The Panel carefully examined the arguments submitted by the parties. The United States essentially argued that the CAFE programme, from its very beginning, was primarily aimed at fuel conservation. The application of the CAFE requirements to imports was essential to avoid nullifying the reduced consumption of fuel resulting from the application of the measure to domestic manufacturers. The EC argued that under Article XX(g) restrictions must be necessary and that the measure was not aimed at rendering the measure as applied to domestic production effective.

5.63 The Panel recalled at the outset that the requirement under Article XX(g), unlike those related to the protection of public morals or human, animal or plant life and health (Articles XX(a) and (b)), or those relating to compliance with laws or regulations not inconsistent with the General Agreement (Article XX(d)), did not require that the measure be necessary. Subject to the requirements of the introductory clause of Article XX, the fact that other less trade restrictive measures, such as a fuel tax, could be used equally and more effectively to encourage fuel efficiency did not imply that the measure could not be justified under Article XX(g).

5.64 The Panel noted that the evidence presented clearly demonstrated that the overall goal of the averaging scheme was to promote fuel efficiency of cars circulating in the United States. It also recalled that it was not the CAFE scheme as a whole but the specific measure inconsistent with Article III:4 that required justification and which, under Article XX(g), needed to be primarily aimed at the conservation of exhaustible natural resources and at rendering effective restrictions imposed on domestic production and consumption.

5.65 The Panel noted that the inconsistency of the CAFE regulation with Article III:4 arose from the fact that the treatment of imported products was dependent on factors not directly

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relating to the products as products: averaging was applied to a particular mix of products determined by the ownership and control relationships of producer/importers. The issue before the Panel was therefore whether the application of this form of averaging to imported cars was primarily aimed at rendering effective conservation requirements imposed on domestic production. The Panel observed that if there were no requirement placed on imported cars, the objectives of the CAFE programme would be prejudiced, as imported large cars would not be subject to any restriction on fuel consumption. Thus the application of fleet averaging to imported cars in a similar manner to its application to domestic cars clearly served the purpose of fuel conservation, and served to render effective the conservation measure. In these respects, fleet averaging met two of the key requirements of Article XX(g).

5.66 This analysis suggested to the Panel that in the absence of separate foreign fleet accounting it would be possible to include in a revised CAFE regulation an averaging method that would render the CAFE regulation consistent with the General Agreement. As such a revised method was only hypothetical at this time (since fleet averaging did not exist independently of separate foreign fleet accounting), and since the CAFE regulation would in the view of the Panel require substantial change if separate foreign fleet accounting were removed, the Panel did not consider that it could or should make a finding on the consistency of a revised regulation. This could only be determined on the basis of the actual elements of a revised CAFE scheme.

(iv) Article XX(d)

5.67 The Panel then noted the United States argument that the assessment of the CAFE penalties, in order to secure compliance with fleet averaging requirements consistent with the General Agreement, was justified under Article XX(d). The United States claimed that the penalties were applied on strictly-defined criteria, did not discriminate among countries, and were not a disguised restriction on trade within the meaning of the introductory clause of Article XX. The EC argued that the issue in dispute was not the conformity of the CAFE penalty payment as such, but the conformity of the underlying legislation. The Panel then examined the text of Article XX(d) which, together with its introductory clause, states:

> "Subject to the requirement that such measures are not applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where the same conditions prevail, or a disguised restriction on international trade, nothing in this Agreement shall be construed to prevent the adoption or enforcement by any contracting party of measures:
>
> …
>
> (d) necessary to secure compliance with laws or regulations which are not inconsistent with the provisions of this Agreement … "

The Panel recalled its finding that the CAFE measure was not a charge under Article III:2, but a requirement under Article III:4 enforceable by penalty payments. The fundamental issue before the Panel, and the object of its finding under Article III:4, was thus the consistency of the underlying CAFE requirement with the General Agreement, not that of the penalty payments as such. Even if the issue of the consistency of the penalty payments as such were examined by the Panel, such payments could not be justified under Article XX(d) since, contrary to the requirements of that provision, the underlying measure (the CAFE requirement) was itself inconsistent with the General Agreement. Accordingly, the Panel found that those aspects of the CAFE regulation found inconsistent with Article III:4 could not be justified under Article XX(d).

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(v) Article III:5

5.68 The Panel noted the EC argument that separate foreign fleet accounting and fleet averaging requirements violated Article III:5, second sentence, prohibiting the application of internal quantitative restrictions so as to afford protection to domestic production. According to the EC, the fleet averaging scheme was an internal quantitative regulation, since it effectively prevented the sale of large cars unless small cars were also sold. Separate foreign fleet accounting afforded protection to the domestic production of small cars, since in order to produce large domestic cars, small cars consisting of at least 75% domestic content had to be produced. The EC also argued that the CAFE measure was inconsistent with Article III:5, second sentence, with respect to car parts. In effect, separate foreign fleet accounting provided an incentive to domestic manufacturers to source domestic parts for small cars in order bring these cars into their domestic fleets and gain the benefits of averaging with large domestic cars. Moreover, less favourable treatment of imports in one case could not be balanced by more favourable treatment in another. The United States replied that the CAFE measure was not an internal quantitative regulation, but a manufacturing requirement. It did not require that domestic content be used, only that a certain level of domestic content be attained in order to qualify as a domestic car for fleet averaging purposes. Moreover, the CAFE measure did not afford protection to domestic production, since there was no intrinsic advantage to being in the foreign or the domestic fleet.

5.69 The Panel observed that Article III:5, second sentence, refers to the general principles set forth in paragraph 1 of Article III and which govern the application of Article III as a whole. Having already found under the specific provisions of Article III:4 that the CAFE measure accorded to cars of foreign origin treatment less favourable than that accorded to cars of domestic origin, the Panel did not consider it necessary to make a finding under Article III:5, second sentence, on the more general issue of whether the CAFE measure also afforded protection to domestic production, or on the issue of whether in terms of Article III:5 the measure constituted an internal quantitative restriction.

D. Cumulative effect of the three regulations

5.70 The Panel then turned to the argument of the EC that the cumulative effect of the three regulations affecting cars imported from the EC led to an additional inconsistency under Article III. The EC showed that in many cases the three measures all affected the same imported cars from the EC, and that the financial impact on imports of EC cars was thereby exacerbated. The Panel observed however that the EC had not shown that the combined effect of the measures in terms of conditions of competition was greater than the sum of their individual effects. The magnitude of the commercial effects would only be relevant for an argument made under Article XXIII:1(b) relating to nullification and impairment of benefits under the General Agreement resulting from the application by another contracting party of a measure that did not conflict with the General Agreement. The Panel did not find therefore that the combined effect of the three measures led to any further inconsistency with the General Agreement than did the three measures considered separately.

VI. CONCLUSIONS

6.1 Based on the foregoing findings, the Panel concluded that

a) the luxury tax on automobiles is not inconsistent with Article III:2;

b) the gas guzzler tax on automobiles is not inconsistent with Article III:2;

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c) the CAFE regulation is inconsistent with Article III:4 and, to the extent that it is based on separate foreign fleet accounting, cannot be justified under Article XX(g) or Article XX(d).

6.2 The Panel *recommends* that the CONTRACTING PARTIES request the United States to bring that part of the CAFE regulation found to be inconsistent with the General Agreement into conformity with its obligations under the General Agreement.

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ANNEX I

Description of Calculation of Model Type Fuel Economy

I. Calculations

A. Figures 1 and 2 illustrate the technique used to get from subconfiguration fuel economy test data to model type. The basic procedure is as follows:

1. Test vehicles are at the subconfiguration level. Therefore, a fuel economy test result will be a subconfiguration value.
2. All subconfiguration data within a given configuration are sales-weight averaged to come up with a configuration fuel economy (not depicted in Figure 1). Untested subconfigurations are not counted in the sales.
3. Once configuration fuel economy is established, the same technique is used to establish the base level fuel economy. Each configuration fuel economy value for a given base level is sales-weight averaged to obtain the base level fuel economy value.
4. A model type may contain one or more base levels. This is because a model type could have cars that fall into more than one inertia weight class for a given carline, basic engine, transmission class combination. Therefore, the fuel economy values for each base level contained in the model type are sales-weight averaged to result in the model type value.

Note that base level fuel economy values may contribute to more than one model type. This is because the same basic engine, transmission class, and inertia weight class are often used for more than one carline. An example of this would be Camaro and Firebird both with a 5.7 litre, fuel injected V-8, and a manual 5-speed transmission, at the 3,500 pound inertia weight class. Thus, because the testing requirements are based on design parameters and not model names, a test result from either the Camaro or the Firebird can represent both.

B. **Harmonic Averaging** - averaging fuel economy values always means harmonic averaging in this context. Essentially, harmonic averaging averages the inverse of the fuel economy values which results in fuel consumption. Fuel consumption is what is really sought, not fuel economy. The latter is a good term for consumer use but not for calculations. The calculation involves inverting, averaging, and then re-inverting to get the fuel economy result. Figure 1 contains an example of sales-weighted harmonic averaging.

C. Model type calculations are performed at least twice for a model year. The first calculation is done prior to model introduction so that vehicle labels can be affixed prior to sale. This is also the time that the model type number is used to determine the gas guzzler tax liability. The model type numbers at this time use projected sales in the sale-weighted averaging. After the model year is over, model type values are again calculated using actual sales and more extensive test data (covering at least 90 per cent of sales by configuration). These model type values are then sales-weight averaged to form the CAFE.

1. **Gas Guzzler Determination** - For the gas guzzler tax, each basel level is represented by at least one test from the highest selling configuration. This can be supplemented by the manufacturer with additional data from other vehicles in the base level. Each model type will have a city fuel economy value and a highway fuel economy value. The gas guzzler tax liability determination is based on a combined fuel economy value. The combined value is a

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harmonic average of the city and highway values, with the city value weighted at 55 per cent and the highway value weighted at 45 per cent.

2. **CAFE Calculation** - As mentioned above, after the end of the model year, and after the manufacturer has completed testing of 90 per cent sales coverage by configuration, model type values are again calculated. For each of the model types, the city and the highway values are combined using the method in 1, above, and the resultant combined city/highway values are harmonic sales-weighted averaged to get a CAFE value.

II. Grouping the Product Line

A. **Model Type** is the level of description used on fuel economy labels and is also the grouping used to assess gas guzzler taxes at the time the label is established. Later, this same grouping is used as a building block for the CAFE calculation. For labelling and the Guide, it provides consumers with a vehicle name (carline), a basic engine description (number of cylinders, displacement, and fuel system), and transmission class (manual or automatic, and number of gears). For example:

Model Type

Carline (Camaro)
Basic Engine (5.7L V-8, Fuel Injection)
Transmission Class (Manual 5-Speed)

B. **Base Level** is a grouping of design parameters that are independent of the model names (carlines) which are contained in them. Since model name is not a factor in the resulting fuel economy of a vehicle, the base level is a calculation step that focuses on the design parameters that do affect fuel economy. Base level is comprised of the same elements as model type, but inertia weight class is substituted for carline in the definition. Inertia weight class is a testing parameter that determines how the dynamometer is set to simulate the weight of the vehicle on the road. Therefore, the base level is a vehicle weight sensitive parameter that goes into the calculation. The same base level may be contained in several model types, and several model types could share the same base level. For example:

Base Level

Inertia Weight Class (3,500 Lb.)
Basic Engine (5.7L V-8, FI)
Transmission Class (M-5)

C. **Configuration** is a finer level of design description within the base level. In addition to the base level parameters, a configuration is also a unique combination of engine code (calibrations), transmission calibration, and axle ratio. Thus, configuration is much closer to (and in many cases is) a final description of an individual vehicle, with respect to fuel economy parameters. For example:

Configuration

Base level (…)
Engine Code (Code 2)

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Transmission Code (Code 1)
Axle Ratio (3.41)

D. **Subconfiguration** is an even finer level of design description that includes equivalent test weight and road-load horsepower. Equivalent test weight is a finer level of dynamometer inertia weight setting, and road-load horsepower is another dynamometer setting determined by the on road drag factors on the vehicle (air drag, drivetrain drag, tire road resistance, etc.). Subconfiguration is the most detailed level of description used in the testing program.

Subconfiguration

Configuration (…)
Equivalent Test Weight (3,375 Lb.)
Road-Load Horsepower (10.3 HP)

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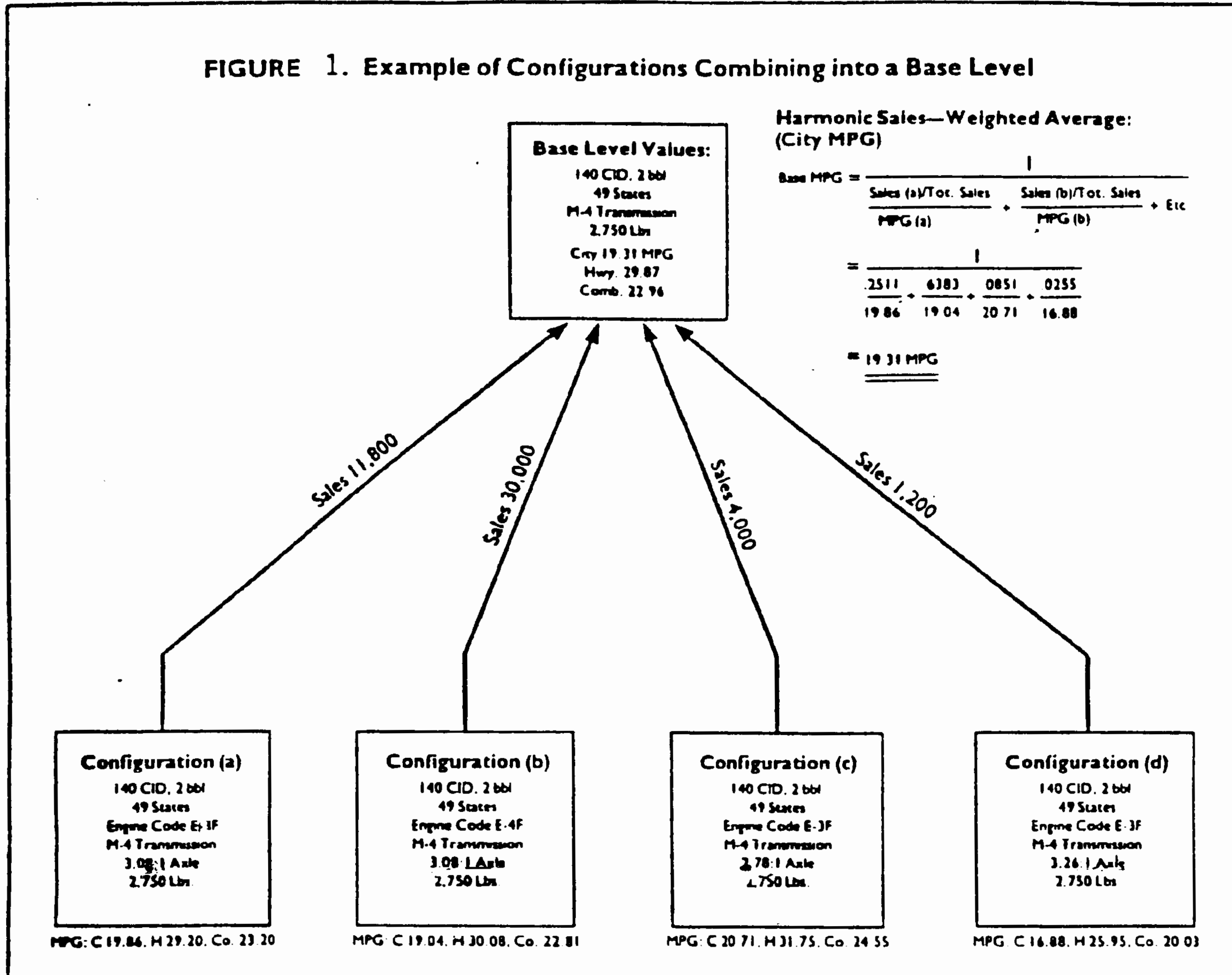
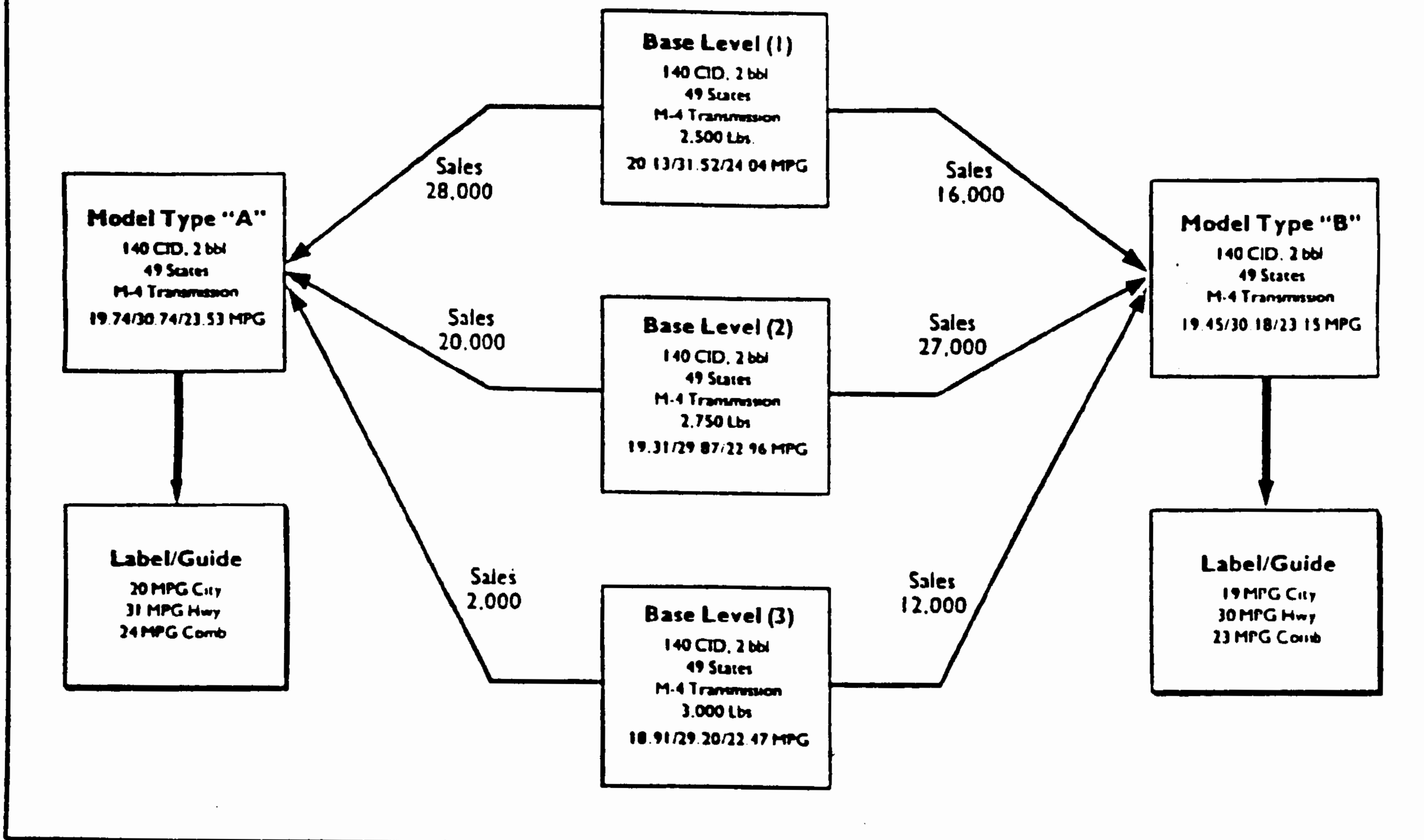
FIGURE 1. Example of Configurations Combining into a Base Level





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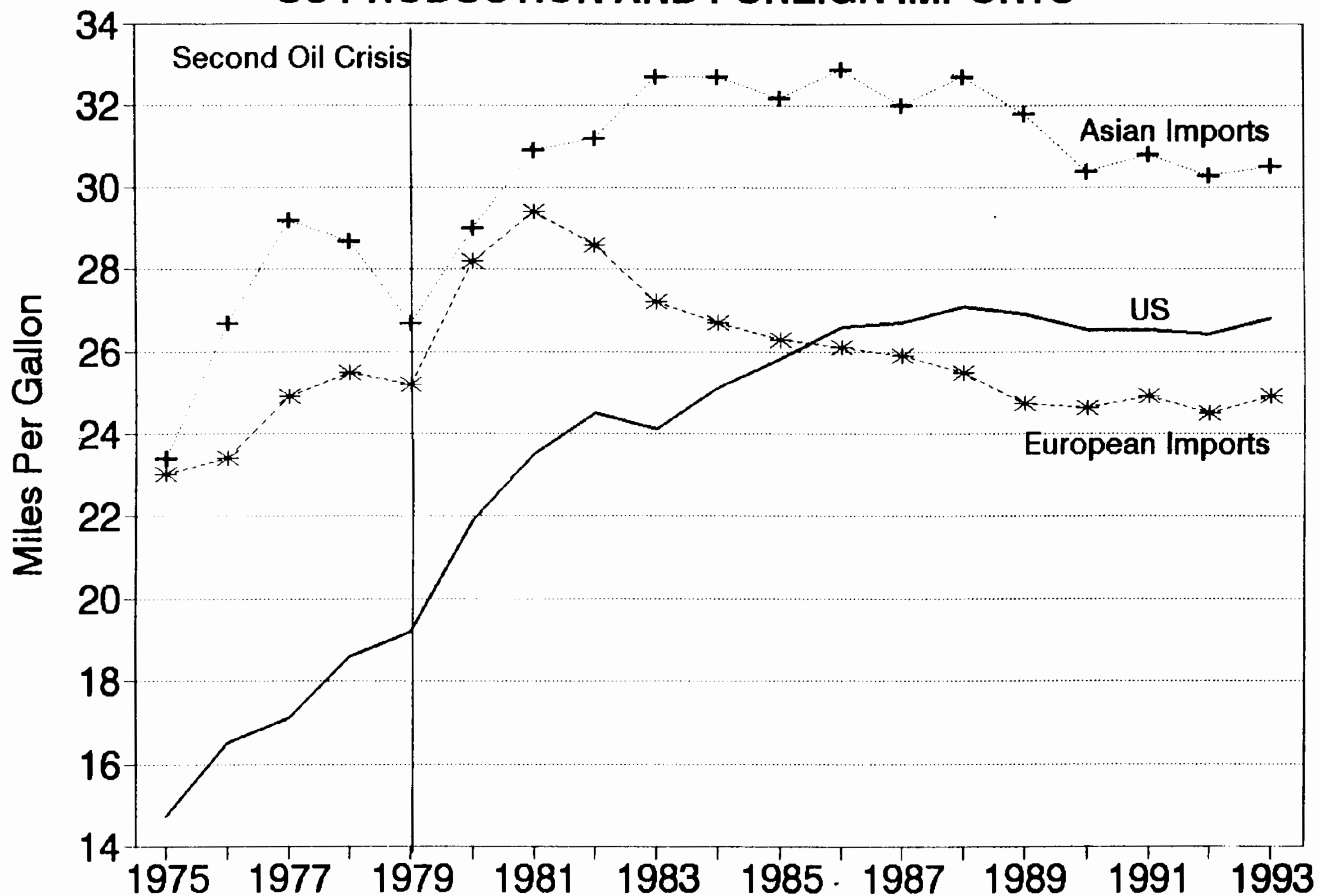

Source: EPA Technical Report EPA/AA/TDG/93-01, "Light-duty Automotive Technology and Fuel Economy Trends Through 1993," May 1993.

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