STUDY ON EC WINES AND LIQUOR EXPORTS TO JAPAN

Volume I: **REPORT**

Report
for the Commission of the European Communities
by PA International Consulting Services Ltd., Tokyo, 1985

STUDY ON EC WINES AND LIQUOR EXPORTS TO JAPAN

Volume I: **REPORT**

September 1985

This publication has been prepared
by PA International Consulting Services LTD., Tokyo, under contract
to the Commission of the European Communities.

CONTENTS

PART A: INTRODUCTION AND BACKGROUND

1. Introduction and Terms of Reference

In January 1985, the EC Commission awarded to PA International Consulting Services Ltd. a brief to carry out a study of EC liquor and wine exports to Japan.

The decision to undertake the study was taken largely because of considerable and long-standing dissatisfaction, among both European exporters and their agents in Japan, about the relatively low level of market penetration of European liquors and wines in the Japanese market. Performance has varied from product to product, with the most serious problems confronting Scotch whisky, which has been losing market share for at least 5 years and achieved only 6% of the Japanese whisky market in 1984. Other EC products have fared better, brandy and wines in particular but concern has also been expressed about their future market growth.

Against this background, the basic purpose of the study was to recommend, based on thorough investigation and analysis, what actions should be taken to increase the overall level of EC exports of liquors and wine to Japan.

The study was designed in two main stages:

- Stage 1 was concerned with assembling basic quantitative market information, examining the regulatory, tariff, tax and other issues and assessing the views of the European interests on the problems facing EC liquors exports in the Japanese market. A significant input at this stage came from the briefing notes provided by the EC Liquor Committee, which is one of several similar committees working in Tokyo under the aegis of the European Business Council and which played its part in formulating the overall structure of the project.

At the end of Stage 1, it was agreed that the key issues to be addressed in the study included:

- liquor tax
- import duties
- parallel imports
- product information and labelling
- retail pricing
- product and market development
- business development in Japan

- Stage 2, in which the consultants undertook a more detailed study of the structure of the market in Japan and examined in-depth the issues listed above.

[Note]: It has been agreed, after discussions with the EC Delegation and the Liquor Committee, that beer would not be covered in any detail in this project. However, some notes on the market for imported beers are included in Appendix 11; these provide basic beer market statistics and present a summary of the reasons why the question of beer has not been examined in depth.

2. Summary of Work Done

All the work necessary for the completion of the study have now been carried out. In the course of our investigations, we have interviewed some 25 organisations involved in Japan in the EC liquor business; in Europe, interviews were conducted with relevant organisations in the main countries producing and exporting alcoholic beverages. Further work has been done in Japan to interview a cross-section of local manufacturers, distributors, wholesalers and retailers engaged in the liquor trade and discussions have been held with the Fair Trade Commission and with selected consumer groups.

In the course of the study, in particularly during the second stage, the consultants have worked very closely with and received substantial cooperation from the members of the EC Liquor Committee.

We enclose in Appendix 10 a complete list of the people and organisations with whom we have been in contact in the course of our study.

3. Structure of This Report

In structuring this study report, we have presented, in Part B, an overview of the Japanese market for EC alcoholic beverages. For the rest, we have written separate Parts covering each of the main issues that emerged as critical in the course of our work. Details are as follows:

Part C: Liquor tax in Japan
Part D: Import duties on liquors
Part E: Parallel imports
Part F: Product information and labelling
Part G: Business and marketing considerations
Part H: Other issues

Supporting data to the report are included in a series of Appendices, which are presented as a separate volume of the overall report. In particular, we draw attention to the series of statistical tables in Appendix 1; these present a comprehensive picture of the history and development of the liquor industry from a statistical viewpoint, up to the end of the 1984 calendar year.

4. Appreciation

Finally, we wish to express our sincere appreciation to all those people, in Japan and throughout Europe who have given us so generously of their time and assistance. Without that support, it would not have been possible to bring this study to a successful conclusion.

PART B: OVERVIEW: THE JAPANESE MARKET FOR EC ALCOHOLIC BEVERAGES

1. Market Performance of EC Wines and Liquors

Two facts immediately strike the observer of the market in Japan for alcoholic beverages from EC supplying countries:

- EC exports to Japan are already substantial and significant. Of the three main exports, Scotch whisky is the largest single product export from the U.K. to Japan and brandy is similarly France's largest product export. Exports of wine, while lower in value than those of Scotch whisky or brandy, are already substantial in volume.

- On the other hand, tax-cleared shipments of imported finished products represent a minute fraction of the total Japanese market, their share of the total volume consumed ranging between 0.8 and 1.0% over the last five years.

In broad terms, the Japanese market for alcoholic beverages has been traditionally dominated by beer and sake, with shochu and whisky the only two other significant products:

- Beer in 1984 accounted for 65% of the total market by volume, this percentage having declined very slowly over the last three years.

- Sake's share at under 19% has been falling away rather more steadily.

- Shochu share has been increasing steadily since the late 1970s and in 1984 it surged from just over 5% to nearly 8%.

- The share of whisky had been stagnant at around 5% for many years but lost almost 1 percentage point with the decline in 1984.

Within this framework, wine is still a very small player with just 1% of total consumption.

Liquor imports into Japan from all sources have been dominated by whisky, wine, brandy and beer as the following table shows:

Imports of Liquors

(Share of import market by type)

Product	Calendar Years			
	Volume		Value	
	1983 %	1984 %	1983 %	1984 %
Whisky	37	38	46	NA
Wine	31	34	19	NA
Beer	15	8	6	NA
Brandy	9	9	22	NA

Looking at the overall import volume trends, whisky has generally declined since 1980, beer dropped steeply in 1984 after 5 years of steady growth, wine shows the most consistent rising pattern, while brandy after some years of steady growth declined marginally in 1984.

In the comparison between bulk and bottled imports:

- For whisky, bulk represents 55% of the total imports by volume with no noticeable trend

- Brandy bulk is 38% of total imports by volume

- For wine, the bulk share of volume is currently 57%, again with no marked trend.

As indicated above, 1984 was a year of significant change in the Japanese liquor market. Shochu volume increased by almost 40% over the previous year. The main sufferer was whisky and the big domestic producers in particular found their whisky volume down over 20% compared with 1983.

Demographic changes in the market structure are having a strong influence on product preferences and major changes in drinking habits are taking place. Women, particularly younger working women, are playing an increasing part in the market; this is one of the reasons for the shift towards softer, milder, blander drinks, in many cases mixes and the remarkable shochu boom. The sufferers have been the hard liquors, with whisky at the forefront. The research studies we have read suggest there is every reason to think these trends will be maintained, though very recent sales patterns suggest some slight reversal of the trends so evident in 1984.

The following paragraphs examine in more detail the position for each of the three major European exports: Scotch whisky, wine and brandy.

1.1 Scotch Whisky

World sales of Scotch whisky in volume, on a strong upward trend throughout the early '70s, peaked in 1978 and the trend has been mainly downwards since, falling particularly sharply in 1983. Figures for 1984 show a small gain, suggesting that the trend has possibly been reversed.

The decline has been almost entirely in bottled sales; exports of bulk have been holding their position quite steadily. Total Scotch export volume declined by 16% between 1978 and 1984, with bottled sales dropping some 22% over the same 6 year period.

These declines have led to substantial shut-downs of distilling facilities in the industry in Scotland and there must be concern that there may be a long-term "product life cycle" trend working against Scotch, reducing its share of total alcoholic beverage consumption in major markets and with a parallel trend towards increased proportions of bulk shipments to some major markets, at the expense of the product bottled in Scotland.

The history of whisky consumption in the Japanese market over a similar period has been somewhat different. From the various statistical tables in Appendix 1 of this report, a number of significant conclusions can be drawn:

- Overall consumption of whisky in Japan increased slowly from 1979 to 1983 (average rate of some 4% per annum). 1984 figures reversed the trend, with a sharp fall of 20%.

- Domestic whisky's share of the total increased steadily from 90% in 1979 to 94% in 1983 but fell back to 93% with the 1984 transformation.

- Sales of imported bottled Scotch in 1984 had fallen to less than 2/3 of the 1979 level, with share of market down from 10% to 6%.

Scotch whisky can only really compete in the special grade sector of the Japanese market. Yet even within this more restricted framework, a deteriorating position has been noted:

- Special grade sales as a percentage of the total whisky market have declined from 58% in 1979 to 50% in 1984.

- The Scotch whisky share of the special grade sector has also been falling, from 16% in 1979 to 10% in 1983. In 1984, however, there was a recovery up to 13%, as Scotch sales have not declined as sharply as have those of domestic brands.

Another significant factor in the Japanese market structure in recent years has been an overall movement down market; the slow trend away from special grade, noted above, has been matched by increased consumption in the very cheap second grade.

1.2 Wine

There are many aspects about the recent perfomance and future prospects of the European wine industry in the Japanese market that are healthy and encouraging.

In total, the wine market in Japan is still relatively small, accounting for a mere 1% by volume of the total Japanese liquor market, and represents, for example, only one quarter of the consumption of whisky.

Encouraging indications are that:

- Domestic unsweetened fruit wine (i.e. table wine) sales have increased by 62% in the six years since 1979.

- Total domestic wine sales (including the declining sweetened fruit wine sector) have increased by 29% over the same period.

- Sales of imported bottled wines have increased by 66% over these six years, increasing their share of the total market from 22% - 27%.

Most members of the trade are quite bullish about the future prospects for wine sales. The current low base is part of the reason for this; Japanese per capita wine consumption is less than 1 litre per annum, compared with 24 litres in Germany, 80 litres in France, 8 litres in the U.S.A. So growth rates of 20 - 30% per annum are discussed, with a potential per capita of as much as 10 litres per annum, i.e. more than ten times the current consumption level per head.

These optimistic projections are supported by evidence of demographic and social changes in the liquor market. The increasing role played by young people, including girls and the trend towards softer, blander, lighter alcoholic beverages, support the case for rapid growth of wine consumption.

As regards the supplying countries for bottled wines: for the past six years, France and West Germany have between them secured approximately 80% of total bottled imports. There have been minor fluctuations over the years and the 1984 figure was 77% with the French holding 43% and the Germans 34%.

Among other countries, the U.S. is increasing its share steadily, currently at 7%, Italian imports are growing more slowly and share is about stable at 6%. Other smaller quantities are coming in from Australia and Spain.

As this report was being finalised, the appearance of poisonous substances in wines sold in Japan, both in imported bottled wine from West Germany and in local wines containing imported Austrian bulk, had become an extremely public issue. It is difficult to guage the longer term effects but a few things are immediately clear:

- One local wine producer is in serious trouble, particularly in terms of loss of public confidence

- This may rub off on the other local wine makers

- The growth pattern in wine sales will be interrupted, at least in the short term.

In particular, public and consumer interest in issues of wine labelling has been aroused and this may well lend support to concerns on this front that EC interests have been expressing for some time.

1.3 Brandy

For the five years 1979 - 1983, brandy enjoyed a rapidly growing market in Japan. In that period, growth in total volume amounted to 76%, following a period of relatively slower growth from the beginning of the 1970s. However, 1984 saw a downturn, with total volume dipping by 5%.

Within the total market, domestic brandies grew faster than imports (almost doubled between 1979 and 1983) and the import share of the market total in fact declined from 34% to around 27% between 1979 and 1983. In 1984, imports lost less ground than domestic brandies (less than 1% down) and their share recovered to 28.5%. Sales of cognac have maintained their market share steadily at around 13% over the period of review.

The cognac market itself is dominated by two brands, which according to trade data share approximately three quarters of the total cognac market between them. Of the remaining brands, only three achieve any significant volume.

2. Causes of the Low Level of Import Penetration

As mentioned earlier, the volume share of bottled imports in the total Japanese market for alcoholic beverages over the past six years has ranged from 0.8 to 1.0%. On this basis, it is estimated that the EC share of the total market has been between 0.6 and 0.8%.

This must be regarded as a very unsatisfactory level of achievement, in particular when one considers the dominant positions of:

- the Scotch whisky manufacturers in the worldwide whisky trade
- the French cognac makers in the world trade in brandy
- French, German and Italian wines

In the course of our studies, a number of reasons for this unsatisfactory performance have been clearly identified.

In the first place, we must note the major shifts in market forces that have been inexorably and measurably taking place in Japan over the last five or six years.

It is not possible in this report to provide a detailed picture of these forces; the following brief summary has resulted partly from our discussions with interested parties in Japan and partly from a review of some of the market research into the subject that has been recently carried out.

The main issues are as follows:

- In the first place, the Japanese economy has, in the last five years, slowed down to modest growth rates of the order of 3/4% per annum. As part of this process, growth in consumer spending has been low and the food and drink segments have been particularly sluggish.

- In particular, corporate expense account spending is being more tightly controlled, affecting both the gift and high-class bar segments on which Scotch and brandy are heavily dependent.

- There have been many social changes at work, too. The involvement of young Japanese in the liquor market has increased substantially. There are more working teenagers in Japan, their involvement with alcohol as increased enormously in the last six years, their expenditures on alcohol are rising and working women and working girls are increasingly participating in the market.

- As an instance of the latter phenomenon, whereas in the overall market (all ages), male consumption of alcohol is four times that of females, in the teenage groups, the split is approximately 50/50.

- These changes are exerting pressures on the whole liquor market, for lighter, sweeter, lower alcohol content and lower priced beverages to fit in with these social changes. The surge in Shochu sales, which is not a new phenomenon in 1984 but has been steadily building up since about 1979, is the prime expression of these underlying shifts. The other side of the coin has been a move away from the harder liquors, with a powerful negative impact particularly on the sale of whisky.

1984 was categorised as a year of revolution in the Japanese liquor markets.

From the evidence before us, we find it difficult to accept that such a revolution was solely or even mainly the result of the relatively minor liquor tax changes implemented in April 1984. Those changes may have acted as the final trigger; but the demographic and social changes at work in the market place have not happened overnight and the Shochu revolution probably started back in the late '70s. The build up in Shochu sales was steady and increasing in momentum before 1984, as was the steady stagnation in the growth pattern of whisky.

Of particularly significance is the fact that even the powerful Suntory has been quite unable to handle these market forces. For the year to March, 1985, Suntory sales value in total fell by 11% from the previous year, whisky volume dropped 26% while operating profit plunged to 43% of the previous level. It was being said by some that an era has ended for Suntory and that its future recovery would be built around new products rather than around a re-vitalisation of the declining whisky market.

However, recent months have produced the first signs of a recovery in whisky sales and some indications that the shochu boom may be running out of steam.

So these are some of the changing dynamics in the market place with which imports as well as local manufacturers are having to contend.

In addition, there is substantial evidence to indicate that the position of the imported product in the Japanese market has been undermined by a variety of other factors. Some of these are factors of a "regulatory" nature in the structure of the Japanese market itself; others have to do with the organisational arrangements and marketing performance of the EC liquor industry.

The key regulatory issues that have been identified are the following:

- The impact of the Japanese liquor tax system on imported liquors
- The impact of certain import duties
- A number of issues in the area of product information and the labelling of Japanese domestic liquors

Of a somewhat different nature is the question of parallel imports, which in the view of the trade have also had a negative impact on the market penetration of Scotch whisky and brandy in Japan.

The question of retail price arrangements in the Japanese market has also surfaced as an area of some concern.

Finally, there are clearly a number of significant areas in which the business organisation and marketing performance of the supplier industries in Europe suggest opportunities for improvement.

These issues are all discussed and recommendations put forward the following Parts of the report.

PART C: LIQUOR TAX IN JAPAN

1. Current Status of Liquor Taxes in Japan

The following sections described in detail the current structure, levels and effects of the liquor tax system. Supporting documentation on the subject of liquor tax is contained in Appendix 2.

1.1 Liquor Tax on Whisky

The Japanese Liquor Tax Law prescribes three grades of whisky: special, first and second. English language translations of these definitions are set out below:

Whisky:

- Special Grade:
  1) Pure malt whisky or pure grain whisky (including blends of pure malt whisky and pure grain whisky).
  2) Liquors with a pure malt whisky or pure grain whisky content of 27% or higher.
  3) Liquors with an alcoholic strength of 43 GL or higher.

- 1st Grade:
  1) Liquors with a pure malt whisky or pure grain whisky content of between 17% and 26%.
  2) Liquors with an alcoholic strength of 40 GL or higher but under 43 GL.

- 2nd Grade:
  Liquors which fall under neither special nor 1st Grade.

Only one standard has to be satisfied for a product to be graded and the highest possible grading will always apply. For example a domestic whisky with a malt content of 27% and an alcoholic strength of only 40 GL would be graded as "special". And a whisky with a 17% malt content at 43 GL would also be a special grade product.

It should be noted that all imported whiskies and brandies are automatically classified as "Special Grade" unless it can be proved that the product should be classified as first or second grade.

Based on this grading system, three seperate tax structures, one for each grade, have been developed.

Details of the history and current status of these taxes are shown in Appendix 2. In summary:

- For each grade there is:

  - <u>A specific tax rate</u> fixed at a certain number of yen per litre of volume, with increments for increasing alcoholic strength

  - An <u>ad valorem tax</u> which replaces the specific tax once stated "barriers" of taxable value (also expressed in yen per litre of volume) are exceeded

- For second grade, the specific rate is ¥296.2 per litre, the barrier ¥570 per litre and the ad valorem rate 65%

- For first grade, the specific rate is ¥1,011.4 per litre, the barrier ¥1,110 per litre and the ad valorem rate 100%

- For special grade, the specific rate is ¥2,098.1 per litre, the first barrier is at ¥1,400, introducing an ad valorem rate of 150%, and a second barrier ¥1,570 per litre, with a corresponding ad valorem rate of 220%.

There are different methods of calculating ad valorem tax for domestic and imported products. In the case of imports, the tax base is usually taken as the C.I.F. cost plus duty. For domestic products, there are two methods:

- The manufacturers' selling price to wholesalers, excluding tax, or

- The retail price less trade margins less tax.

This latter is officially described as a "special case", applicable when the retail price is known. In practice, it is applied widely to calculation of tax on domestic whisky. (See Appendix 2.2)

Certain pricing implications of this method of calculating tax will be examined at a later stage in our study.

1.2 Liquor Tax on Brandy

Brandies, like whisky, are subdivided into three grades, on exactly the same basis of classification as whisky.

The liquor tax structure for some brandy is also similar:

- There is no difference between brandy and whisky as regards the specific tax rates.

- The ad valorem percentage rates are also the same; however, for brandy, the barriers above which the ad valorem rates apply are significantly higher for the 220% ad valorem rate.

The methods for calculating ad valorem tax for domestic and imported products are the same as for whisky.

1.3 Liquor Tax for Wine

Details of the history and current status of the liquor taxes on wines are shown in Appendix 2. They have been amended four times in the last 10 years, most recently in May 1984.

The tax rates currently applicable to standard table wines are as follows:

- A specific tax at ¥60.4 per litre (¥49.7 per litre if C.I.F. + Duty less than ¥450/l), up to a barrier of ¥1,020 per litre. Once the taxable value exceeds this barrier, ad valorem tax at 50% is applied.

Taxes for bottled imports are based on the C.I.F. cost plus duty; for domestic products, tax is calculated either on the manufacturers selling price (excluding tax) or on the retail price less trade margins less tax.

1.4 Liquor Tax on Liqueurs

Two different rates of liquor tax are applied according to the C.I.F. price and the customs duty.

a. Specific Tax

When the C.I.F. (+) duty cost is less than ¥1,230 per litre (¥861 per 70cl) liquor tax is charged as follows:

	Strength	Tax per litre
Alcoholic strength of 15% or higher and extract of 21% or higher	15%	¥367
	16% or higher	Addition of ¥24.47 per every 1% exceeding 15%
Others	less than 13%	¥117.3
	13% or higher	Addition of ¥9.78 per every 1% exceeding 12%

b. Ad valorem Tax

When the C.I.F. (+) duty cost is more than ¥1,230 per litre (¥861 per 70cl) liquor tax is charged as follows:

	Tax barrier between specific tax and ad valorem tax (per lire)		Tax rate
Alcoholic strength of 15% or higher and extract of 21% or higher	When the container capacity is		
	20cl or less	¥1,420	100%
	More than 20cl	¥1,230	100%
Others	20cl or less	¥1,420	50%
	More than 20cl	¥1,230	50%

2. Concerns Raised by EC Interests

The following conclusions can be drawn regarding the liquor tax as applied to whisky:

- The method of assessing tax is unique, at least as far as major world markets are concerned. The method in all EC countries (except Denmark and Greece) and in the U.S.A. is to levy on all spirits a specific duty, related to the volume of alcohol in the product.

- The method used in Japan has two clear effects:

  - it generates three sharply defined product categories, with very different tax levels and therefore different retail prices. Taking specific tax only, special grade whisky pays approximately twice as much tax as first grade and seven times as much as second grade. (For details, see Appendix 2.6)

  - the ad valorem component, based on cost, effectively penalises the higher quality (because higher cost) products.

- It can thus be said that the system of grading and the related tax calculation has discriminated sharply in favour of the inferior grades and has created new product and price categories not normally found in other whisky markets.

For brandy, because the systems of product definition and tax calculation are similar to whisky, the conclusions must also be similar. However, whereas in the case of whisky the classification or grading system has produced three sharply defined product/price categories with more than half the domestic market in the lower two classes, the brandy situation is different and the sharp price segmentation has not occurred so strongly. Some 2/3 of total brandy shipments from domestic suppliers have been of special grade.

It is, however, true that the ad valorem tax component does penalise high quality/high cost imports and places most cognac up at around ¥12,000 per bottle retail.

One direct result of the tax and duty system has been that grape brandy, which is used as a gift and also in the kitchen for cooking and retails at between ¥3,500 and ¥5,000 per bottle, is losing market share in face of competitively priced local products aimed at the same market segment.

As regards wine, there is general agreement that the combined impact of tax and duty favours the domestic product at the low end of the market (retail prices of, say, ¥1,200 per bottle downwards), whereas the combination, because of the method of levying tax on domestic products, theoretically favours imported wines at retail prices above this level (though in practice, very little local wine falls into this category).

A further effect has been to produce two clearly defined main market segments:

- A cheaper segment, mainly paying specific duty.

- A more expensive and very high quality segment, usually paying the ad valorem duty.

European wines are established in both segments. In the upper segment, with the duty and tax treatment and with obvious quality and image advantages, imported wines, particularly French and to a lesser degree German, hold strong positions. In the lower priced segments, most importers and in fact most of the German wine exporters are operating with some success, keeping below the ad valorem duty barrier and marketing their products retail at around ¥1,200 - 1,500 per bottle.

However, there are signs that the future volume growth, in take-home business, will be at the bottom end of the market, with prices at or below ¥1000 per bottle. It is here that the future growth of imported wine appears threatened.

The above comments have been made on a product-by-product basis. In addition, the overall structure of the liquor tax is the subject of concern, the causes of which are clear from the table below:

Product	Tax (y/l)	Index (Special Grade whisky = 100)
The 'Whisky Category' (which includes brandy)		
The minimum rates for all whisky and brandy are:		
'Special' grade (not exceeding 43% vol)	2,098.1	100
'First' grade (" " 40% vol)	1,011.4	48
'Second' grade (" " 37% vol)	296.2	14
Other spirits, eg vodka, (not exceeding 37 vol)	361.8	17
Shochu		
- Type A (Ko-rui) (25% vol)	78.6	4
- Type B (Otsu-rui) (25% vol)	50.9	2
Liqueurs		
- "15% or higher and extract of 21% or higher" (15% vol)	367.0	17
- "Other" (13% vol)	117.3	6
Sake		
- 'Special' grade (16% vol)	608.64	29
- 'First' grade (15% vol)	279.5	13
- 'Second' grade (15% vol)	107.9	5
- Synthetic	81.6	4
Fruit Wine		
- "Sugar content exceeds 26 g, or extract is 7% or higher"	159.8	8
"The Others"	60.4	3
"Cheap and peculiar to Japan"	49.7	2
Sweetened Fruit Wine (less than 13% vol)	117.3	6
Beer	239.1	11

Note: Taxes are stated in yen per litre of product.

As is clear from this tabulation, special grade whiskies and brandies are particularly heavily taxed. To quote some examples, the minimum rate for special grade whisky is:

- 41 times the rate on shochu (Otsu-rui)
- 27 times the rate on shochu (Ko-rui)
- 7 times the rate on 2nd grade whisky
- twice the rate on 1st grade whisky

To sum up: the main areas of concern, which are regarded as distorting the patterns of trade and of consumer demand for liquors and obstructing the natural flow of imports of liquors into Japan are:

- The system of tax barriers and ad valorem tax structures as it affects all imported liquors.

- The three different levels of tax applied to the three grades of whisky and brandy as defined.

- The overall levels of tax paid on the entire range of liquors, in particular the highly favoured treatment of shochu compared with other beverages.

3. <u>Liquor Tax in Major Overseas Markets</u>

To provide one possible framework for reviewing the existing Japanese liquor tax structure, we have examined the structures in comparable developed economies overseas, i.e. the major countries of the EC and the U.S.A.

The position can be summarised as follows; full details of the relevant overseas tax structures are set out in documents included in Appendix 4.

EC Countries

In the main, liquor taxes in EC countries are levied as follows:

- On spirits, as a specific tax per volume of pure alcohol. In the major EC countries (France, Germany, Italy, U.K.), taxes on most spirits are at the same absolute level; in Germany, in particular, all spirits pay the same amount of liquor tax per volume of pure alcohol.

- On wine, no tax is raised in Germany, Italy or Greece. In other countries, tax is charged at a specific rate per volume of product, in most of these countries with one rate for wines up to 15% alcohol and a higher rate for those above 15%.

- For beer, taxes in major EC countries are also charged at a specific rate per volume of finished product or at an intermediate stage of production. In each case, the rate normally increases with increasing alcoholic strength.

The underlying principle is clearly to relate the amount of tax paid to the amount of alcohol in the product, either, in the case of spirits, by a direct relationship or, with wine and beer, by adjusting the tax rate as alcoholic strength increases.

In no major EC market are ad valorem taxes raised on alcoholic beverages. In fact, the only markets in the EC where ad valorem liquor taxes are found at all are Greece and Denmark, which represent a small proportion of EC production.

U.S.A.

The tax structure in the U.S.A. is almost identical in principle with that of the major EC countries:

- All distilled spirits pay a standard specific tax of \$10.50 on each proof gallon (this to be increased to \$12.50 on October 1st 1985).

- On wines not more than 24% alcohol by volume, taxes are charged at specific rates per wine gallon, the rates increasing as the percent of alcohol increases. Champagne and other sparkling wines are taxed on the same basis but at higher rates. Wines with more than 24% alcohol by volume are taxed as distilled spirits.

- On beer (with minor exceptions), a fixed specific tax is charged per volume of product.

As in the EC countries, it is again noteworthy that all the taxes in the U.S. are specific, related (except in the case of beer) to volume of alcohol. There are no ad valorem taxes in the relevant parts of the U.S. system.

4. Possible Directions of Change

4.1 Objectives and Criteria

We have described in a previous section the ways in which the current Japanese liquor tax system appears to distort the patterns of consumer purchase; we have also described the liquor tax systems used in EC countries and the U.S.

In proposing possible alterations to the current Japanese system, our prime objective was to remove discrimination, within each category, between domestic and imported products. To this end, specific sub-objectives were:

- To simplify the system and, where possible, to follow the principles applied in major developed economies overseas

- To remove specific anomalies, for example the disproportionately low rate of tax currently charged on shochu compared with other distilled spirits

- To remove the three-level tax system currently applied to whisky and brandy. This method of taxing in three classes was first introduced for sake in 1949. The subsequent extension of this system applied only to whisky and brandy, not to other spirits (e.g. shochu), fruit wine, sweetened wines, etc.

- To remove ad valorem taxes from the system. In our view, these taxes create specific problems:

    - they are, in effect, a tax on quality and widen the price gap between high cost/high quality products and low quality products

    - on imported products, they impose a tax on import duty, as duty forms part of the taxable base

    - the system leads to manipulation by local producers and importers, to position their products below the tax barrier.

    - air freighting of high quality wines can become uneconomic with high ad valorem duties charged on the air freight cost.

It is also noted that no advanced country overseas has ad valorem taxes on liquors. They appear to be mainly used in developing countries for the purpose of protecting fledgling local industries.

It would obviously be important to ensure to the extent possible the maintenance of overall government revenues from liquor tax. It is noted that liquor taxes are a high proportion of government revenues in Japan (6.1%, compared with 1.4% in the U.S.A. and 1.9% in West Germany). However, given the need to reduce government deficit financing, it would be inappropriate for the contribution from the liquor tax to be reduced at this stage.

In drafting our proposals, we have also studied carefully the "Statement of Demands Concerning Liquor Tax and Other Matters" presented by the Japan Spirits and Liquors Makers Association to the President of the LDP Tax Administration Research Committee on September 29th 1984. As will be shown later in this report, our proposals appear to respond very closely to the demands of this Association.

4.2 Tax Structure

Two specific proposals are made:

First, there should be five basic groups of liquor for tax purposes. This represents a significant simplification compared with the current 10 groups.

The proposed groups are:

- Sake (including synthetic sake and mirin)
- Spirits (including the existing shochu, whisky and spirits categories and derivatives)
- Wine (both fruit and sweetened wine and derivatives)
- Liqueur (the existing group)
- Beer

As indicated in section 3 above, liquors in the EC and U.S. markets are divided into three groups: spirits, wine and beer, for tax purposes. It seems appropriate to increase the number of groups to five in the Japanese case because:

- Sake is a unique product, not to be combined with other groups of liquor

- The "liqueurs" specification in Japan contains a wide variety of substances which it would be difficult to combine logically with any other group

This classification would, among other things, remove an existing anomoly whereby the indigenous product shochu pays far less tax than vodka, though the two are, for all practical purposes, the same product.

<u>Second</u>, the principle for levying taxes should be that of charging specific taxes related either to the volume of alcohol or in one specific case to the volume of product. Wherever feasible, a single standard level of tax is proposed for each of the five major groups.

4.3 Detailed Proposals

In order to develop specific tax proposals, the following methodology was adopted for each of the proposed five liquor groups:

- For the two calendar years 1983 and 1984, using National Tax Administration Agency data, the total volume of product cleared and the total tax levied for the group was calculated

- The equivalent volume of alcohol for each product was calculated.

- The average tax per kilolitre of product and per kilolitre of alcohol were obtained.

- The effective tax rates per kilolitre of alcohol for the group for the two years were used as a basis for proposing the new tax levels.

Using this methodology, the following detailed results and proposals were obtained:

4.3.1 Spirits

The calculation based on National Tax Administration Agency data for the 1984 calendar year is set out in the table below:

Spirits

(based on 1984 calendar year)

Product	Product (kl)	Alcohol (kl)	¥Mn Tax	¥Tax per kl/prod.	¥Tax per kl/alc.
Whisky	305,230	126,060	388,064	1,271,382	3,078,407
Brandy	22,772	9,405	41,079	1,803,926	4,367,783
Spirits	40,710	19,541	12,130	297,961	620,746
Shochu	543,333	135,833	38,394	70,664	282,656
Total	912,045	290,839	479,667	525,924	1,649,253

Thus the average tax per litre of alcohol for the spirits group as defined in 1984 was ¥1,649.3.

Carrying out the same calculation for 1983, the resultant tax per litre of alcohol was ¥1,900.6. The reason for the decline in 1984 was, of course, the increase in volume sold of lowly taxed shochu.

As overall liquor tax revenues declined in 1984, mainly because of the shochu boom, it may be considered prudent to aim to recover some of this tax by setting the new tax at a rate of, say, ¥1,850 per litre of pure alcohol for the spirits group. If consumption remained on the 1984 pattern, revenues would increase by some ¥58 billion.

The table below shows the effects of the proposed tax in Yen per kilolitre of product, compared with the existing specific taxes.

Spirits

Comparison of existing and proposed tax levels
(Yen/kl of product)

Product		Existing specific tax	Proposed tax
Whisky/brandy:	Special grade	2,098,100	795,500
	1st grade	1,011,400	740,000
	2nd grade	296,200	684,500
Shochu:	Ko (25%)	78,600	462,500
	(20%)	56,600	370,000
	Otsu (25%)	50,900	462,500
Other spirits		Similar to whisky/brandy	

A new tax on these lines would have two clear effects:

- It drastically narrows the gap between the three grades of whisky/brandy, thus removing one of the major concerns of importers and one of the major perceived anomalies in the existing tax structure.

- It also significantly raises the tax level on both types of shochu, thereby meeting one of the main concerns of the local manufacturers.

Taking normal distributor and trade margins, the approximate effects at retail level of the proposed tax changes per 750 ml bottle would be:

- Special grade whisky reduced by ¥1,740
- First grade whisky reduced by ¥360
- Second grade whisky increased by ¥520
- Shochu (Ko-type 20%) increased by ¥420

So, for example, a 720 ml bottle of Jin Soft Shochu, currently retailing for ¥520, would increase to around ¥920.

4.3.2 Wine

The calculations for wine for the 1984 calendar year are shown in the table below:

Wine

(Based on 1984 calendar year)

Product	Product (kl)	Alcohol (kl)	¥MIO Tax	¥Tax	
				kl/prod.	kl/alc.
Fruit wine (11%)	74,551	8,200	7,578	101,649	924,146
Sweetened wine (16%)	16,431	2,629	2,311	140,649	879,084
Total	90,982	10,829	9,887	108,692	913,196

On the basis of 1984 data, the average achieved tax per litre of alcohol was ¥913.2.

For comparison, the calculation was done for 1983 but the achieved tax per kilolitre of alcohol was in all cases lower. For fiscal prudence, it is therefore proposed that the 1984 figures could be used as the basis for a proposed new tax.

A new tax could therefore be proposed at the rate of ¥925 per litre of pure alcohol.

On the basis of 1984 consumption levels, the tax revenue on this basis will increase by some ¥130 million.

Comparing the effective taxes per kilolitre of product:

- A fruit wine of alcoholic strength 11% (average for this class) would pay ¥101,750 per kilolitre, compared with current rates of ¥159,800, ¥60,400 or ¥49,700, depending on the product specification.

- A sweetened wine at 16% alcohol would pay ¥148,000 per kilolitre, compared with the current ¥156,400.

It is difficult to specify in detail the effects on retail prices because of the wide variety of products on the market. For fruit wine, the most significant category, the overall effect would be to increase marginally (by less than ¥100 per 750 ml bottle) retail prices for the lowest price wines; prices currently at or above ¥2,500 per bottle would be noticeably reduced, mainly because of the elimination of the ad valorem tax on higher priced wines.

Note: As an alternative to a tax on wine based on volume of alcohol, a tax on volume of product could be proposed, as this is the structure in EC countries and the U.S. In this case, based on the 1984 tax data, taxes of ¥110 per litre (up to 15%) and ¥150 per litre (over 15%) could be appropriate.

4.3.3 Sake

The calculations, using the same method, are set out in the following table:

Sake and Mirin

(based on 1984 calendar year)

Product	Product (kl)	Alcohol (kl)	Tax ¥MIO	¥Tax kl/prod.	¥Tax kl/alc.
Sake (15.9%)	1,368,905	217,656	269,185	196,643	1,236,745
Mirin (13.5%)	75,880	10,244	5,584	73,590	545,100
Total	1,444,785	227,900	274,769	190,180	1,205,656

The figures for 1983 produced a lower rate of tax per kilolitre of alcohol.

It is therefore proposed that the overall rate of ¥1,210 per litre of alcohol could be applied.

The result would be to produce no noticeable change in the average retail price of sake. However, the price gap between special, first and second grades would be narrowed because, under the proposed system, the tax variation between grades would be very greatly reduced.

4.3.4 Liqueurs

For this very small group, in terms of volume consumed and tax raised, the effective tax per litre of alcohol in 1984 was ¥676.7. It is proposed that a rate of ¥680 per litre of alcohol be adopted for this highly diversified product group.

(Note: some mix products currently in this category, such as chu-hai, would be re-classified, following these proposals, according to their derivation, eg. "spirits-based" classified as spirits).

4.3.5 Beer

Beer is not a major subject for study in this project. As regards tax, there would appear to be no reason to alter the existing tax level of ¥239.1 per litre of beer.

5. Comments on Likely Effects of the Changes

5.1 Fiscal Effects

In attempting to assess possible fiscal effects of a proposed new tax structure on the above lines, it should be noted that, of the total liquor tax revenue, some 98% comes from taxes on beer, whisky, sake, brandy and shochu. These are, therefore, key items to be considered.

Of these key items, there seems no reason why, purely as a result of the proposed tax changes, there should be any change in the trends of consumption of either beer or sake. Their tax levels are not significantly affected by the changes, whereas the tax levels and prices of most other lower priced products in the structure would increase. For beer and sake, therefore, the fiscal risks appear to be negligible.

As regards shochu, which is one of the most adversely affected products under the proposed new structure, there is likely to be a significant reduction in sales volume. However, given the structure of the suggested tax changes, shochu volume would need to drop to below 15% of its current level for tax revenues to actually decline. This seems highly unlikely. If, in fact, shochu volumes fell to about half the 1984 level, that is down to the volume of the period 1979 to 1982 prior to the recent shochu boom, tax on shochu under the proposed new rates would increase by some ¥70 - ¥80 billion per year.

The critical remaining question is: what would happen to whisky and brandy under the proposed new structure? This is almost impossible to predict. However, if total whisky consumption recovered from the low of 1984 back to the level of, say, 1983 (before the shochu boom), then the loss of tax on whisky because of lower rates for special and first grades would be approximately equal to the likely gains from shochu taxes as assessed above.

There seems, therefore, to be a basic case for arguing that the likely overall fiscal effect of taxes along the lines suggested would tend to be close to neutral.

5.2 Effects on Local Spirits and Liquor Manufacturers

The Japan Spirits and Liquor Makers Association, in their "Statement of Demands Concerning Liquor Tax and Other Matters" of September 29th 1984, made a series of demands in relation to liquor tax. As will be seen from the following comments, all the demands made by the Association in respect of liquor tax are, in fact, met by the proposals made above in this report.

Demand I was concerned with the correction of disproportionate liquor tax laws on spirits and liquors. The prime concern was with the high levels of tax imposed on whisky, particularly special grade and the very low levels of tax paid by other spirits, in particular by shochu. The above proposals, which significantly reduce the tax amounts on special and first grade whisky and increase the tax amounts on shochu, should go a long way towards eliminating the anomalies and distortions in the market place discussed in the Statement.

Demand II is concerned to correct the alleged unequal assessment standards for domestic vs. imported liquors. Under this demand, the claim is made that domestically produced spirits pay tax on advertising expenses, administrative and other expenses whereas the imported products do not. This concern of the local makers only arises because of the existence of ad valorem taxes in the liquor tax structure. Under the above proposals, ad valorem taxes would be removed from the structure; so the alleged unequal assessment standards claimed by the local producers would no longer exist.

Demand III is concerned with the classification of spirits and liquors and seems, like Demand I, to be directed mainly towards reducing tax load differentials by simplification and rationalisation of the system. The proposals made in this report achieve a significant simplification of the liquor classification system, in particular by including all spirits, including shochu, whisky and brandy, under the same classification. The quoted differential between the tax on spirits and that on shochu would largely disappear under the proposals made above.

Demand IV addresses the application of proportionally diminishing tax rates related to the alcoholic content of the product. Our proposals would involve (for all products except beer) introduction of taxes at a specific rate per volume of alcohol in the product. Thus, in all cases, the tax would increase or decrease in direct proportion to the alcoholic content. In this way, the problems identified under Demand IV would be overcome.

Demand V is concerned with aspects of the administration of the liquor tax and the changes requested seem perfectly reasonable.

The other demands in the paper are concerned with questions related to customs duties.

Thus it would appear that the key issues addressed by the Association in its paper, as far as liquor tax is concerned, would be effectively addressed and the anomalies and problems would be eliminated by the adoption of the tax proposals that have been put forward in this report.

5.3 Combined Tax and Duty Burden

Part D of the report examines import duties and suggests possible directions of change.

The combined effects of proposed tax and duty changes must also be assessed and this is done below in Part D, section 5.2.

PART D: IMPORT DUTIES ON LIQUORS

1. Current Status of Import Duties on Liquors

The tables in Appendix 3 set out in detail the current import duties levied on imports of liquors entering Japan and the new rates announced on June 25th 1985 to be introduced as part of the "Action Programme". Also given in that Appendix are tabulations showing the historical trends in these duties.

New duty rates on major products are planned to be introduced as follows:

- Whisky and brandy (bulk and bottled) as soon as possible in 1986 and certainly before April 1.
- Still wine (bulk and bottled) by April 1, 1987.

The position product by product, is summarised briefly below. Current duties are shown first, with the new duties in brackets following:

Whisky

As shown in the tables in Appendix 3, duties on imports of Scotch whisky are as follows:

- For bulk, ¥370 per litre (¥296 per litre)
- For bottled, a range from ¥299 to ¥332 per litre, calculated within this range on the basis of 36% ad valorem (¥246.40 per litre)

Thus, at the current rates, the bulk duty rate is nominally between 11% and 24% higher than the rate for bottled whisky. However, after allowing for the "dilution factor" for bulk, which is usually imported at around 60 GL, the actual bulk rate per litre is ¥265 or between 11% and 20% below the bottled rate.

Wine

Duties on imports of still wines are levied as follows:

- Bulk wine

  Standard rate ¥80/l (¥64/l); preferential (GSP) rate ¥30/l (¥24/l)

- Bottled wine

  A range from ¥166/l up to ¥280/l, with the actual amount within this range calculated on the basis of 38% ad valorem (a range from ¥132.80/l to ¥224/l, calculated at 30.4% ad valorem).

Prior to the Action Programme, changes in wine duties were introduced in April 1985. The effects of these changes on most bottled wine duties can be shown to be minimal. On the other hand the reduction of the standard and already low preferential rates on bulk wines significantly reduced the costs of local wine bottlers using imported bulk. As bulk imports can comprise as much as 95% of the ingredients of wines bottled in Japan, the saving was clearly important.

Brandy

As shown in the tables in Appendix 3, duties on imports of brandy are as follows:

- For bulk, ¥345/l (¥276/l)
- For bottled, ¥407/l (¥325.60/l)

Thus there is a fixed differential of ¥62 (¥49.60) per litre in favour of bulk.

2. Summary of Action Programme Changes

The table below summarises the changes in duty, under the Action Programme, affecting the major EC bottled imports:

Product	Tariff	
	Existing	New
Scotch Whisky (bottled)	¥299-332/litre (basis 36% ad val)	¥246.40/litre
Wine from fresh grapes (bottled)	¥166-280/litre (basis 38% ad val)	¥132.80-224/litre (basis 30.4% ad val)
Brandy (bottled)	¥407/litre	¥325.6/litre

3. Concerns Raised by EC Interests

Our interviews with EC liquor interests have identified the following areas in which they regard Japanese import duties as discriminating against European liquors:

- In the first place, they regard the general level of Japanese import duties on liquors as high and significantly higher than those applicable to Japanese imports into EC markets.

- Scotch is treated unfavourably compared with Bourbon or rye whisky imports, which pay ad valorem duties of 24.5% and 28% respectively (estimated as approximately half the amount paid on standard Scotch).

- The gap between duty on bottled table wines and bulk table wines is wide and became wider with the duty changes of April 1985. In the worst case, bottled imports can pay over nine times the duty on bulk imported at the preferential rate.

The June 25th announcement provides minimal help in these areas and in one aspect penalises EC imports further. As will be shown below, a 20% cut makes little impact on the gap between Japanese and EC duties; while the changes perpetuate the Scotch disadvantage versus bourbon and rye.

4. Comparison of Japanese and EC Import Duties on Liquors

In the course of the study, the consultants have made detailed comparisons between the duties on imports of liquor coming into Japan from EC suppliers and those entering EC markets from third country sources. In Appendix 5, documents are included setting out the relevant import duty rates for imported liquors into EC and U.S. markets, and in Appendix 5.2, a comparative table of Japanese/EC duties is given.

Note: In converting overseas duty rates into equivalent yen rates, the following exchange rates have been used:

- 1 ECU = ¥185
- US$1 = ¥250

From this analysis, the following picture of Japanese and EC duties can be presented:

- Whisky

  - On bottled whisky, Japanese imports into EC countries would pay ¥46.25 per litre while imports into Japan pay from ¥299 to ¥332 per litre. Thus the Japanese tariff is 6.5 to 7.2 times higher than the EC one.

  - On bulk, the EC duty is ¥39.77 per litre, the Japanese duty ¥370 per litre. Thus the Japanese duty is 9.3 times higher.

  - The relationship between the tariff on bottled and that on bulk whisky, after allowing for dilution, is approximately the same in both the Japanese and EC cases.

- Bourbon

  On bottled bourbon, the EC duty is ¥44.66 per litre while the Japanese duty at 24.5% ad valorem is estimated to be around ¥150 per litre. The Japanese duty is 3.5 times higher than the EC equivalent.

- Whisky/Bourbon

  - In the EC, the duties on imported bottled whisky (Scotch) and Bourbon are almost identical; the difference is only 4%.

  - In Japan, the duty on Scotch is around twice the duty on Bourbon.

- Brandy

  - On bottled brandy, the Japanese duty at ¥407 per litre is 2.8 times the EC duty at ¥145.78 per litre

  - On bulk brandy, the Japanese duty is 2.7 times the EC duty.

- Sparkling Wine

  - The EC duty on bottled sparkling wine is ¥74.00 per litre.

  - The Japanese equivalent is ¥360 per litre or 4.9 times greater.

- Table Wine Not More Than 13% Bottled

  - The EC rate is ¥26.83 per litre.

  - The Japanese rate ranges from ¥166 to ¥280 per litre, which is between 6.2 and 10.4 times higher than the European level.

- Wine Not More Than 13% Bulk

  - The EC duty is ¥20.17 per litre.

  - The Japanese duty ranges from ¥30 to ¥80 per litre depending on country of origin. The Japanese rate is thus 1.5 to 4.0 times greater.

- Bottled Wine/Bulk Wine

    - In the EC tariff, bottled table wine not more than 13% pays a tariff approximately 1/3 higher than the equivalent bulk.

    - In Japan, the duty on bottled table wine imports is between 5.5 and 9.3 times higher than the preferential bulk rate and between 2.1 and 3.5 times the standard rate.

Summarising this analysis, the key areas of concern are the following:

- In the first place, the overall levels of Japanese duties on bottled imports are between three and ten times higher than the EC equivalent duties.

- The combination of these relatively high import duties with ad valorem liquor taxes produces high multiplier effects on the total duty-plus-tax paid by the higher quality imports. In effect, a tax is paid upon a tax.

- The huge gap in duty between bottled and bulk table wine imports is regarded as inequitable. It enables Japanese bottlers (whose products can legally contain as much as 95% imported bulk) to land their raw materials paying duties between six and ten times lower than those levied on bottled imports.

- The relatively wide differential between the Japanese tariff on whisky compared with bourbon is regarded as unnecessary discrimination against Scotch whisky.

The June 25th announcement will only reduce the Japan/EC duty gap to 80% of the present level. Thus, overall duty levels on bottled imports will, from April 1987, still be between 2.2 and 8.3 times higher than EC equivalents; and the gap between bottled and bulk wine duty will widen marginally for the period April 1986 to April 1987.

Note: Reviewing U.S. import duties in a similar manner, it is found that:

- U.S. duties on imported bottled table wine are very similar to those in the EC.

- Duties on bulk table wine are slightly higher than those on bottled, thus giving a duty advantage to the bottled product (the reverse of the Japanese situation).

- U.S. duties on sparkling wine are very similar to those in EC countries.

- U.S. duty on imported Scotch whisky is about one third of the EC rate; this makes the current Japanese whisky duties between 19 and 21 times the U.S. equivalent.

Another, possibly more relevant, comparison can be made between the duties imposed on those products that are locally made, because in most cases these products bear the higher duty rates; for example, Japan imposes higher duties on Scotch than it does on rye or bourbon, so does the EC (though the gap is very small), while in the U.S. the reverse is the case.

If we compare, in the field of whisky/bourbon/rye, the higher or 'protective' duties imposed in each country, the position is as follows:

	¥/litre
Japanese duty on bottled Scotch	299 - 332
EC duty on bottled Scotch	46.25
U.S. duty on bottled bourbon	19.16

Thus the Japanese duty is 6.5 to 7.2 times the EC level and 15.6 to 17.3 times the U.S. level.

It can be concluded that, examined from various angles, Japanese import duties on the key liquor products are invariably far higher than the comparable imposts in the EC or the U.S.

On this basis, a number of specific proposals will be developed in the next section of this report.

5. Possible Directions of Change

In considering possible proposals for change in the levels of Japanese import duties on liquors, the following two alternative principles could be applied:

- The first principle would argue that as between Japan and the EC, two advanced industrial economic areas both having well developed and diversified liquor manufacture, equity and free trading principles would suggest that the Japanese import duty structure could be brought down to approximately the same levels as those currently used in EC markets. This is a very powerful proposal. It would demonstrate Japanese willingness not to go on protecting an industry which ought not to need such protection any longer; and perhaps more significantly, given the tremendous basic potential for increased import volumes, particularly in wine, it would at one stroke make possible a very significant impact on the whole issue of Japan/EC trade imbalance and friction.

- The second approach would be to examine the competitive retail prices of major imported and domestic liquors and, on the assumption that the proposals for liquor tax changes set out in Part C are adopted, to make a commercial judgement as to the maximum level of import duties that would be compatible with a reasonable competitive situation between the domestic and the imported products. This is in most respects a far less attractive proposal.

5.1 Proposals for Equalisation of Import Tariffs on Liquor as between Japan and EC

The detailed development of a proposal along these lines would be relatively straightforward. It would involve, at a selected and appropriate ¥/ECU exchange rate, the calculation of corresponding Yen duty rates using the same duty basis as in the EC schedules.

An alternative approach, which would allow more flexibility on the Japanese side and would be equally appreciated from the EC viewpoint, would be the development of a new Japanese import duty structure built on components from both the U.S. and the EC current tax schedules. For example, a system could be developed using the higher of the U.S. and EC duties for each specific item.

5.2 Maximum Duty Levels for Reasonable Competitive Balance

In the consultants' view, this is in almost all respects the less attractive of the two options. This is because:

- It is not built upon the principle of duty equality between major developed nations and would not even provide a starting point for the eventual achievement of that goal.

- It would involve a piecemeal restructuring of parts of the tariff to meet specific problems, rather than a fundamental restructuring of the whole system on a common basis.

- It would also, to some extent, leave unresolved the inequity in the wine business caused by the very low preferential duty rate for imported bulk.

With these reservations, a set of adjustments to existing tariffs could be proposed, each designed to overcome specific anomalies and inequities in the existing structure. In making these proposals, assumptions have to be made about future levels of liquor tax, to assess the combined fiscal burden and the effect of this on retail prices.

The main components would be as follows:

Whisky

Assuming the implementation of the liquor tax proposals in Part C above, a reasonably competitive situation in the whisky market in Japan could be achieved by a reduction of the existing duty on Scotch whisky by 35% to approximately ¥200 per litre. (If actual tax changes fall significantly short of the proposed levels, no amount of duty adjustment would help; for whisky, tax is the key.)

If this were achieved, we believe that with some minor adjustment to product costings and margins, a pattern of retail prices for major domestic and imported qualities could be achieved as follows:

Whisky Price Comparisons

Basis: liquor tax: ¥1850/litre of alcohol
import duty: effectively ¥200/litre

Product		Retail Prices (¥)	
		Estimated New	Current
Domestic Whisky			
Suntory	Red (720 ml)	1,300 - 1,320	900
	White (760 ml)	1,370	1,620
	Old (760 ml)	1,570	3,170
	Royal (720 ml)	3,000	5,000
Scotch Whisky			
Basic Standard 43 (750 ml)		2,000	4,150
Premium Standard 43 (750 ml)		2,300	4,150
Intermediate 43 (750 ml)		3,000	5,000
Deluxe 43 (750 ml)		5,000	8,500-10,000

Note: To indicate the relative impact of tax and duty changes: in the case of Premium Standard Scotch above, over 90% of the total retail price reduction results from the tax change.

As will be seen from the above table, the total range of whisky prices would be considerably condensed under such a scheme. The key features are as follows:

- Prices of the lowest grade of domestic whiskies would rise.

- Prices of first and special grade whiskies would decline, the former modestly, the latter by a substantial amount.

- The relationship between Suntory Old and premium standard Scotch whisky would move in favour of Scotch in absolute terms (price gap narrowed from ¥980 to ¥730) but in favour of Suntory in percentage terms.

To address the existing inequality between duties on Scotch whisky and those on bourbon and rye, it would seem reasonable under this proposal for all forms of bottled whisky to be set at the same rate of ¥200 per litre.

Table Wine

Before developing proposals for change, it will be useful to examine the impact of existing duty and tax rates on local and imported wines at various price levels. These are shown in the table below:

Table Wine

Comparisons at Current Duty/Tax Rates
(¥/750 ml bottle)

Item	Local	Imp.	Local	Imp.	Imp.	Imp.	Imp.
C.I.F. or Factory Cost	250	250	400	400	554	555	1000
Duty*	9	125	9	152	210	210	210
	259	375	409	552	764	765	1210
Tax	37	45	45	45	45	383	605
Into Store	296	420	454	597	809	1148	1815
Duty/Tax) % C.I.F. or) Factory Cost)	18	68	14	49	46	107	82
Retail Price (St'd Margins)	600	850	950	1200	1650	2350	3700

* Duty on domestic product assumes average mix of 39% imported bulk, 37% grape must, 24% local grape.

The table pinpoints several effects:

- The large difference in duty impact on imported bottled wine compared with local product using a proportion of imported bulk. The difference escalates as the C.I.F. increases.

- The impact of ad valorem taxes from a C.I.F. of ¥555/bottle. A single yen on the C.I.F. adds some ¥700 to the retail price.

In order to develop a more equitable structure of duty, it has been assumed that the tax proposals set out above in Part C are introduced. If this is achieved, import duties at 65% of the current levels (or just over 80% of the rates to be introduced in April 1987) would produce a reasonably competitive scenario, as follows:

Table Wine

Comparisons at New Duty/Tax Rates
(¥/750 ml bottle)

Assume: - duty at 24.7% ad val., minimum ¥108/litre, max ¥182/litre

- tax (as per Part C) at ¥101.75/litre

Item	Local	Imp.	Local	Imp.	Imp.	Imp.
C.I.F. or) Factory Cost)	250	250	400	400	555	1000
Duty*	7	81	7	99	137	137
	257	331	407	499	692	1137
Tax	76	76	76	76	76	76
Into Store	333	407	483	575	768	1213
Duty Tax %) C.I.F. Factory) Cost)	33	63	21	44	38	21
Retail price (St'd Margins)	700	850	1000	1200	1600	2500

* Duty on domestic product assumes average domestic/bulk/grape must mix, as before.

This structure has the effect of significantly narrowing (but by no means closing) the cost/price gap at the bottom end. It also reduces prices at the top end, mainly through the disappearance of ad valorem taxes.

For comparison, on the basis of the new Action Programme wine duties to be introduced in April 1987, and maintaining the same tax assumption as above, the imported products listed in the table above would achieve retail prices as follows: (¥/750 ml bottle):

C.I.F.	250	400	555	1000
Retail	900	1250	1700	2600

On the other hand, a tax outcome significantly different from the one proposed would have a marked impact on the maximum equitable duty levels.

Brandy

It would seem appropriate to reduce the import duty on bottled brandy to approximately ¥265 per litre, i.e. by the same percentage of reduction as was used with whisky and wine.

Conclusion

Having developed these suggestions for detailed product-by-product duty adjustments, the consultants re-affirm their view that the real interests of all concerned would be best served by implementing thorough-going tariff equalisation proposals as set out in 5.1 above.

PART E: PARALLEL IMPORTS

The next issue that has been raised strongly by some liquor trading interests both in Europe and in Japan is that of parallel imports.

The products subject to parallels being the well established and leading brands in each sector, the concern relates mainly to the top brands of Scotch whisky and brandy; minor brands are less subject to parallel imports and wine at this stage hardly at all.

As this is a question on which strongly differing views are held by the various interested parties, let us initially make a brief statement of these differing attitudes and views as we understand them.

1. Summary of Arguments

There are two basic schools of economic thought on the question of parallel imports:

- on the one hand, there is the school that seeks to achieve maximum economic efficiency through free and open competition and the inter-play of market forces. Adherents of this school tend to oppose all constraints on trade: at one level, protectionist constraints on international trade, at another level, constraints on, for example, retail pricing, parallel imports, etc., as limits to free competition and therefore, as barriers to economic efficiency. This could be called the 'macro' view.

- on the other hand, there is the view that economic efficiency is best achieved, at micro level, through profit maximising of the individual firm. Profitable firms create jobs, make investments, in fact are the driving force of a capitalist economy. Many firms seek to maximise profits by designing unique products for particular market segments and spending money on relevant forms of promotion to secure a protected market niche for their products. From this standpoint, parallel imports are regarded as a threat to effective marketing and should, therefore, be controlled. We could call this the 'micro' view.

The macro view is the basic argument for the free market or free competition. Its objective is to provide consumers with the goods they seek, with a fully operational price/volume mechanism at work in the market. It normally presupposes a significant number of producers supplying basically similar goods to numerically large consumer markets. It works best when there are no constraints on the freedom of trade: when everyone is free to buy to and sell from everyone else.

Such a system, if functioning properly, provides genuine market control over prices. Any supplier whose prices are above market rates, for products that are basically not differentiated from his competitors, automatically loses sales.

The free market system is typically seen in the marketing of commodities: coal and other minerals, metals. Competition in these markets is mainly, though not entirely, price-based. In consumer products, the phenomenon of generics (basically unbranded, medium quality merchandise sole on price through supermarkets) are an example of this trading system at work.

In the marketing of consumer goods of all kinds, including liquors, the operation of free trading mechanisms, like for example the free flow of parallel imports, is seen as beneficial by adherents to the 'macro' view. Parallels provide extra, competing channels of distribution, they increase the penetration and visibility of the product in the market and they cut across the established pricing mechanisms of the regular marketing channels, benefitting the consumer and increasing sales.

In the case of major brands of Scotch and brandy, all these effects are seen to some extent; this is claimed to include increased sales (20 - 30% of total sales of leading brands are estimated to be parallels), at any rate in the short term.

The micro view starts from different premises. During the past half century or more, large sectors of western suppliers of products or services, for both consumer and industrial markets, have adopted a business philosophy in which they:

- identify broadly which product/service areas and which market sectors they aim to handle

- through market research and other means, develop an understanding of the present and future needs of customers in the target market segments

- design and develop specific products to meet those needs and identify the products to consumers by means of brand name, packaging and other forms of presentation

- communicate information about the product, by means of advertising, salesmen and other forms of promotion

- set up efficient distribution networks, to deliver the product/service at the right time and place and at lowest cost, to the user.

This whole process aims, in essence, to set up mini-monopolies or franchises, avoiding direct price-competition by providing and promoting products/services with unique benefits. Long-run maximisation of corporate profits is believed to be best achieved by this process.

For branded Scotch whisky and brandy, the marketing process is said to require, among other things:

- A sales force in Japan, to promote the product to the retail (and wholesale) trade channels

- Advertising and promotion expenditures (always high in Japan to make any impact), to generate demand at consumer level and pull the product through the distribution system

- Financial support for the distribution and servicing of the brand

- A price structure that provides room for these necessary marketing expenditures.

The basic reason why parallel imports are regarded, under the 'micro' view, as harmful to brand marketing is that they undermine this process; they reduce or remove the margin necessary to pay for selling, advertising and promotion. Eventually, these activities may have to be reduced or eliminated and that would (if the philosophy of brand marketing is correct) lead to the decline and final disappearance of the product; alternatively, the same product is on sale at widely varying prices, which undermines consumer confidence and market stability.

2. Investigations Carried Out

In the course of our interview programme, both in Japan and in Europe, the question of parallel imports has been reviewed fully with all the manufacturing, trading and public organisations with whom we have been in contact.

To gain additional perspective:

- We have held discussions with officials of the Fair Trade Commission in Tokyo on the subject.

- We have identified other product categories subject to parallel imports in Japan and held interviews with manufacturers and traders involved in these products.

From these various researches, we believe sufficient input has been obtained on all sides of the case for the consultants to reach valid conclusions.

3. Analysis

3.1 Liquor Trade Attitudes

In Section 1 above, our description of the "micro" view of parallel imports provided a basic summary of the position that is held very strongly by all the appointed agents/distributors that we interviewed in Japan and by the suppliers involved in Europe.

These views are reinforced by the domestic manufacturers, wholesalers and retailers whom we interviewd. Summarising the views from these sectors:

- Top brands are the ones to suffer most from parallel imports
- Prices at retail level are reduced by 20 - 30% as a result of parallel imports
- In the process, the parallel importer takes a 'free-ride' on the demand-creating and distribution expenses incurred by the regular distributor
- In the short-term, parallel imports can increase sales but in the long-term they can destroy the market for a product
- Current stagnant sales of imported Scotch are largely the result of parallel imports.
- Despite much discussion, there seems in practice to be no method by which parallels can be controlled.

3.2 Other Product Areas

Other product areas that have been identified as being subject to parallel imports in Japan are:

- High priced automobiles
- Swiss watches

In the case of motor cars, we interviewed Japanese subsidiaries of European manufacturing principals; their views would therefore reflect those of their parent companies in Europe. A selection of local importers and dealers have also been covered. The main comments were that:

- The products most affected are among the most successful models, Mercedes and BMW in particular, the second and third largest brands (after VW) in Japan.

- The parallel importer cashes in on demand created by the regular distributors, who incur expenditures on marketing, advertising, workshops, spare parts supply, customer service, etc. for the purpose. The parallel importer normally does not create demand or provide services along these lines and it is argued that this cannot be classified as "fair trade".

- In many cases, the parallel import is not sold at reduced prices.

- In some cases, cars not fully meeting Japanese standards are imported and successfully marketed by parallel importers. The regular importers make sure the products are modified so as to fully meet local safety and other requirements.

- Checking and recalling models found to be defective is usually difficult when the car has been imported by parallel channels.

- Finally, the parallel importer bringing in limited quantities of motor cars enjoys simplified procedures for clearing and landing the goods; regular importers handling larger volumes have to undergo more lengthy and costly procedures.

In the case of the Swiss watches, our interviews were with a trading company and with a subsidiary of a Swiss watch maker. The comments were as follows:

- The most popular models are the ones subject to parallels.

- Prices on parallel imports are heavily cut (by up to 30/40%) primarily because the parallel importer does not undertake demand-creating expenditure on advertising and promotion or on a sales force.

- Parallel imports are often retailed in outlets outside the distribution channels which the manufacturer has selected for his product. This creates dissatisfaction with the established channels .

Because of the threats to their trade, one Swiss manufacturer has, in fact, established a most comprehensive system of control, both in Switzerland, in Japan and in third countries, which enables him effectively to eliminate parallel imports from the Japanese market.

3.3 Summary of the Brand Marketing Position

In each of the products examined, the manufacturer has deliberately adopted a policy of "brand marketing". In summary, this means that he has:

- Designed his product to meet the perceived needs of buyers in selected segments of the consumer market.

- Identified the most appropriate retail outlets for his products and set up a distribution system designed to channel his products through those outlets to the consumers.

- Created consumer demand for the product by expenditure on different forms of promotion, including media advertising, trade shows, retail displays, point of sale support, product tasting, etc.

- Ensured the sale of his product through the distribution system into the retail outlet, by means of a sales force.

- Targeted on a retail price range at which he believes consumers will purchase the product in appropriate volume and one that will provide an appropriate profit above the marketing and manufacturing costs and overheads incurred.

In other words, the manufacturers involved have a clear view of the marketing programme they believe best suits their product and try to control their marketing activities in line with this programme.

Examples in the liquor trade in Japan would include:

- Premium brands of Scotch retailed as gifts in department stores

- Cognac marketed through high-class bars

What happens when parallel imports enter the scene is that the manufacturer's ability to manage the marketing of his product is disrupted or in some cases destroyed. In the case of Scotch whisky and brandy, the ingredient of the marketing plan affected has been primarily price.

In summary, then, the manufacturer through the parallel import phenomenon loses control of all or part of the process through which he plans to market his products. In our opinion, this is the key argument on this side of the case. Others put forward by distributors (e.g. that they are losing a proportion of their sales and profits to the parallel importer) may be true and painful for the importer but not a valid argument at the level of principle.

The next question is: does a manufacturer have the right to maintain control of the marketing of his product? In this context, a number of comments can be made:

- The decision by a manufacturer to handle his product by the "brand marketing" method (as defined) is, obviously, a basic and fundamental policy decision, in most cases carefully and deliberately taken.

- Such a decision means that in the manufacturer's considered judgement, the brand marketing approach, including (by definition) the necessary advertising, promotion and selling support, is the best way to achieve maximum marketing performance.

- Other methods, including that of putting the product on sale with little or no marketing support and selling at lower prices, have been deliberately rejected as unlikely to achieve the best marketing result.

- A very large number of industries, product sectors and individual companies employ the brand marketing approach for wide ranges of products in large numbers of markets, clearly in the belief that it will produce the best performance in the market place.

In our view, it is reasonable for manufacturers who have chosen the brand marketing route, to use every avenue legally open to them to make sure that this route is actually followed. In particular, brand marketing requires marketing expense (on advertising, sales forces, etc.), to create awareness of and demand for the product with the consumers and to ensure availability of product in retail outlets; and manufacturers must take steps to ensure that the pricing structure leaves room for these expenditures to be made.

3.4 Fair Trade Commission

The views of the Japanese FTC on parallel imports can be summarised as follows:

- The basic FTC position on parallel imports is that it regards them as a positive force in maintaining competition in the market place. Not only will the FTC undertake no steps to restrain parallel imports; on the contrary it will take (and already has taken) steps against any organisation found preventing or hindering parallel imports of genuine goods.

- From the documents presented in Appendix 6, it can be seen that:

    - the FTC maintain that hindrance of parallel imports of genuine goods is likely to constitute an unfair trade practice prohibited by the Antimonopoly Act.

- importers in Japan entering into sole import distributorship contracts with overseas firms are given guidance to the effect that hindering unjustly parallel importation of the goods covered by the contract is a restriction which is likely to constitute an unfair trade practice.

- The history leading up to the present policy is well known. Prior to 1970, it was held that parallel imports impaired the rights of the sole importer as licensee of the trademark on the goods. However, in the Parker case in 1970, it was held that these trademark rights are not impaired, provided the product imported by parallel method is a legitimate and genuine product. This finding was re-enforced in the Lacoste case earlier this year, in which a similar judgement was handed down.

- So ever since 1970 and the Parker case, the FTC has held that parallel imports are in no sense an illegal activity and on the contrary, that the prevention of parallel imports could be considered as an unfair trade practice.

- The reasons given by the FTC for their support of parallel imports are that in general terms they benefit the consumer. They provide an additional ingredient of competition against the potentially monopolistic position of the sole distributor and are likely to lead to lower market prices and hence to more satisfied buyers and increased sales. There is clearly an implication that the monopolistic position of the sole distributor provides opportunities for raising prices.

- Finally, the FTC is, of course, aware, that the EC has adopted basically similar arguments about freedom of competition and hence about parallel imports, and they find it somewhat "embarrassing" that widely diverging views on the question of parallel imports are expressed by different groups of interests in Europe.

3.5 Sales Effects and Trade Flows

The main arguments presented by the supporters of parallel imports relate, in the final analysis, to two issues:

- Consumers benefit through being able to buy the product at lower prices (usually 20 - 30% off for liquor and sometimes as high as 40%), and through a wider selection of retail outlets.

- As a result of lower prices and wider exposure, extra sales of the brand in question are achieved.

Trade estimates put the parallel share of imports of top brands at around 20 - 30%.

The counter argument asserts that the overall effect of parallels has been to reduce import volume. Parallel imports of Scotch started in substance around 1979 (for a variety of reasons) and that was the time when the 5 year downward trend in Scotch sales also started. The degree of "cause and effect" is, however, difficult to establish, as other variables were undoubtedly at work; but it can fairly be claimed that retail price reductions of the type and magnitude created by parallels have clearly not been sufficient to prevent a significant fall in volume.

For the future, it is reasonable to argue that if parallel imports were to be shut off to-morrow, the short-term effect would be a volume loss which could be as high as 30% for affected brands, as goods at discounted prices disappeared from the shops.

The longer term effects are much more debatable and we have found no sales or survey data on which to base a solid case, one way or the other. One the one hand, it is likely that some of the existing consumers of parallels at low prices would switch to substitutes and be "lost"; on the other hand, traders at all levels here feel strongly that such losses would be more than recovered, through a more stable price structure, enhanced confidence of regular consumers and better trade margins.

However, on the evidence obtained to date from our researches, these views must, in the last resort, be regarded as no more than opinions, albeit strongly and deeply held on both sides.

4. Summary

There are thus two basic positions on the issue of parallel imports, one almost diametically opposed to the other; and the forces on each side of the case are both fundamentally convinced of the rightness of their arguments and of their causes.

It is not, in fact, surprising that this should be so, for the objectives of the various parties involved are far from identical. In the eventual long-term, it could perhaps be argued that all are pursuing very similar objectives; in the case of EC liquor exports for example, there is a shared long-range goal of maximising liquor sales to Japan. However, such broad, generalised goals are highly misleading; as soon as the means for getting there are examined, sharp differences soon emerge. For instance, a major part of the platform of the free marketeers is to protect consumers against monopolistic behaviour; whereas one of the goals of the brand marketer, seeking to design products with unique appeals, is to creat little product monopolies in selected market segments.

Given the situation, it is difficult to avoid an impasse. No way has yet been found to demonstrate the inherent rightness or wrongness of either argument. In particular, the specific question whether product imports are helped or hindered, short and long term, by parallels, can not yet be answered on a basis of factual evidence. Lacking such answers, each group will continue to believe in its own cause.

5. Concluding Comments

The consultants' sympathies, it must be said, lie strongly with those aiming to restrict parallel imports. We say this because we think that if a manufacturer has deliberately opted for the brand marketing route, with all that entails in terms of long-term expenditure on brand promotion and support, there is little justice in his being prevented from implementing this policy, because of the actions of traders with no real commitment to his (or often any other) brand.

There is one course of action open to and already used by the industries in some cases, that provides total protection against the phenomenon of parallel imports.

Products that are designed specifically and uniquely for the Japanese market (examples are Johnny Walker Old Harmony and White Horse Extra Fine) are, by definition, not exposed to parallel imports. Such products are supplied only to the exclusive distributor on a direct basis.

We will comment in Part G of this report on the need for constant product innovation and improvement in order to succeed in the Japanese market. This is true of liquor as it is of any other product and, as will be seen later in the report, there will be increasing pressure in future on European liquor exporters to tailor and develop their products and their packs for Japanese consumption. To the extent that they do this, they will progressively reduce the proportion of their Japanese range that is open to parallel importing and thus steadily reduce the threat from this quarter.

Finally, it must be noted that if the proposals on tax and duty (Parts C and D) are achieved, removing ad valorem charges from the structure, it would then be feasible, under different pricing arrangements between principal and agent, to eliminate much of the margin on which parallels exist.

PART F: PRODUCT INFORMATION AND LABELLING

In the course of our study, it became clear that all the European interests involved felt that certain practices of Japanese liquor manufacturers, tolerated by Japanese authorities, particularly as regards product labelling, were misleading to Japanese consumers and damaging to the interests of EC liquor imports into Japan.

In this Part of the report, we will set out the issues and concerns raised by the EC interests, examine the regulatory situation in Japan in respect of these issues and look at the question whether in fact Japanese consumers are misinformed or not. The impact of the current poisoned wine controversy will also be assessed.

Finally, certain recommendations to address these issues will be put forward.

1. Concerns Raised by EC Interests

1.1 Whisky

Labelling problems, an area of significant expressed concern for the industry in Europe and the trade in Japan, arise basically from the vagueness of the requirements in Japan for ingredient listing in whisky. (Some background information on this issue is provided in Appendix 9.3). The overall conclusion is that the standards drawn up for domestic and imported whiskies provide scope for local manufacturers to label some of their products, particularly their second and first grades, in ways which the EC whisky interests consider misleading to the consumer.

Enclosed in Appendix 7.2 are photocopies of a selection of labels from domestic producers' whisky products. As will be seen from these:

- Second grade whiskies, whose content of pure malt or pure grain whisky is by definition less than 17%, label their raw materials as malt, grain and spirits.

- First grade products, which by definition cannot have a content of malt whisky or grain whisky in excess of 26%, label their raw materials as malt and grain. "Spirits" are not specified.

It is our understanding that there are "voluntary" codes, drawn up in 1980 after public hearings, and approved by the FTC, specifying the procedures for labelling ingredients in whisky. These codes, basically to be policed by the industry itself, require that whisky ingredients be listed but do not require percentages to be given. The labels currently used by domestic manufacturers are therefore not in violation of the codes and in no way in violation of any "law". Separate "voluntary" codes were drawn up for domestic and imported products but they seem to be similar in all key aspects.

This aspect of Japanese practice is certainly unusual. The definitions of whisky used in other countries are significantly tighter (as indicated by the material provided in Appendix 9); furthermore, ingredient labelling requirements in Japan itself are quite rigorous in other industries, such as food and pharmaceuticals. There would appear to be a case for the application of much more rigorous requirements to the labelling of alcoholic beverages.

So the issue could be addressed from three directions:

- That the whisky labelling situation is not consistent with the very tight regulations existing in Japan for ingredients' labelling on, for example, food products and pharmaceuticals.

- That the standards drawn up and their effects are markedly different from the situation in all other major whisky markets.

- That there is an issue of consumer misinformation in the current labelling practices of Japanese distillers.

This latter argument will gain strength as a result of the current wine controversy. Consumer criticism of the labelling practices of local wine makers could well spill over into the local whisky industry.

1.2 Wine

There are several areas of concern in connection with the labelling of wine products in Japan, arising because of the lack of precise regulatory requirements regarding labelling procedures.

As a result, wines bottled in Japan, which may contain as much as 95% imported bulk wine, need bear no indication of the proportions or the source of these ingredients. In fact, as the product is labelled "made in Japan" or some similar wording, it might be assumed that the Japanese consumer understands he is drinking a pure Japanese-grown product (though this labelling is not always noticeable).

As with whisky labelling, it appears that currently no rules or regulations are being violated; there is no current requirement for the identification of ingredients or the origin of ingredients on Japanese wine bottles. However, the appearance of poisonous substances in local wines has opened up the issue of identification of origin of ingredients; and substantial public pressure is likely to be exerted for a tightening of wine labelling regulations and for the development of better legislation covering the wine industry as a whole.

The other and more straightforward issue concerns the use by Japanese manufacturers in their labelling of French words, French names, German script and other devices, with a clear implication that the product is in some sense of European origin.

Enclosed in Appendix 7.3 are some examples of labels on Japanese produced wines. As these example show, there is considerable use of French words, initials etc., giving (at the very least) a very strong French flavour to the presentation of the product.

The general question of misrepresentation of country of origin is covered, under the rules of the Paris Convention (to which Japan is a signatory) by the FTC notification No. 34 and the related Guidelines (see Appendix 8). The latter have apparent major loopholes in them in that they effectively permit "corrective labelling". In other words, any use of European looking or sounding words is acceptable as long as, somewhere on the bottle, there is an indication in Japanese that the product is made in Japan.

So again, under current regulations, there is strictly speaking no violation taking place; however, the problem persists and action is still needed to redress it. In this context, the 'poisoned wine' controversy could also generate pressure for tighter regulations on this issue as well.

1.3 Brandy

Substantial concern has been expressed by European interested parties at the widespread use by Japanese brandy makers in their labels of the terminology of the French brandy grading system.

The French system of grading (V.S.O.P., X.O., etc.) is used to designate brandies that have been aged for a specific number of years; but Japanese brandy using these designations has not, apparently, been aged according to the European regulations.

There appears to be a strong case for requesting that these internationally recognised descriptions be correctly used in Japan on the grounds of not misleading the Japanese consumer about the nature of the product.

The situation here is straightforward, as standard rules exist in France, observed by all brandy makers, which set down the minimum number of years of aging for each grade used.

We understand an agreement exists between France and U.S.A., whereby the latter country respects the European rules. A similar agreement should be sought with Japan, so that the rules can be applied to Japanese brandy producers.

Other concerns relating to brandy are:

- The need for protection of denomination of origin

- The fact that Japanese brandy sometimes contains alcohol not made of grape

2. Are Consumers in Japan Misinformed?

This is a very difficult question to assess because there is a dearth of real information on the subject. It is an important issue, however; and there was a general concensus among the various parties contacted during our study that the best basis for addressing these labelling problems would be by relating them to specific evidence of consumer misinformation.

Our enquiries have not identified any valid research done in Japan in this area of misrepresentation. It is generally stated by traders that Japanese consumers are not at all well informed about the qualities; manufacturing methods and ways of evaluating products like whisky and wine. This was confirmed in one research study made available to the consultants, which touched on some aspects of Japanese consumer knowledge of wines. In general, and certainly compared with consumers in European countries or the U.S., the level of understanding is very low in this country. For example:

- There is a general understanding that France in particular and also Germany are producers of high quality wines.

- However, there is little real understanding, on a broad basis, of the criteria for judging wine quality and deciding what to buy. For example, the whole system of aging is an area where Japanese consumers are in the main quite ignorant.

- Awareness and recognition of major European growing areas (Mosel, Bordeaux, etc.) is again remarkably low.

- There is an overall unfamiliality with the wine industry, with the way it develops and markets its products. In particular, the whole system of labelling and identification of wines, much of it in French or German, usually not related to established brand names, is a source of confusion for the Japanese consumer.

- One interesting research finding that because of this lack of understanding and because of the multiplicity of labels and types of European wine, Japanese consumers often find the business of selecting European wine extremely difficult. In consequence, many of them do not buy European wines at all. They back off and select from a range of better known Japanese brand names.

As regards whisky we have not found any comparable research. However, from trade interviews, the same picture of a generally high level of consumer unawareness and ignorance also prevails. It is also indicated that the Japanese consumer is by and large indifferent to many of these refinements e.g. the contents of Scotch whisky, the whisky aging processes, wine vintaging, etc.

One of the consumer groups we interviewed made comments on the question of labelling and consumer information. They suspected that the intention of Japanese manufacturers in their labelling practices might well be to mislead the consumer. However, in their experience, there was at that time no evidence to support this and certainly no complaints from consumers had been received by them.

From the F.T.C. also, we received the comment that, so far as they are aware, there is no evidence of consumers being misled and they, too, have not received any specific complaints on this issues.

However, the situation has now changed markedly as a result of the current debate over poison in wines. A feeling is now developing that consumers have, in fact, been consistently misled by Japanese wine-makers, particularly in describing as 'made in Japan' wines containing over 90% imported bulk. This is already exerting pressure on the industry to change its labelling practices substantially.

3. Possible Actions

We are aware that all of the questions raised in this part of our report have already been the subject of discussions in EC-Japan trade negotiations at various levels up to and including the most recent Trade Expansion Committee and high level talks. In response to EC requests on the question of wine labelling, we understand that guidance has now been given to Japanese manufacturers that they must indicate their company name clearly in Japanese on the front label of their products; there is also a requirement that the place where the product is made in Japan must also be shown.

Our views on these issues are now summarised:

- It is likely that some Japanese consumers are misled by a Japanese manufacturer's wine labels into believing that their products have some European association; and there is now, without doubt, a degree of public suspicion of local makers on the question of non-identification of imported bulk. On the basis that that some Japanese consumers now clearly feel they are being misled, EC representations on these issues are likely to meet a much more positive response than has been the case in the past.

- It is not possible, given the existing lack of data, to quantity the effect on sales of imported liquors that would result if the EC requests in this area were fully met. However, as indicated above, there are sufficient and growing indications of customer confusion for these problems to be raised strongly in future Japan/EC trade negotiations. It is therefore recommended that the EC continue to press for corrective actions to address the issues raised in this Part of the report.

- Another significant finding from our review of these labelling questions relates to the confusion that is being created in Japanese consumers' minds by what they regard as the very complicated multiplicity of labels on European wine bottles. In fact, in our view the whole question of consumer misinformation should also be addressed by EC interests taking positive steps in the labelling, presentation, branding and marketing of their own products. In Part G of this report, where we discuss business and marketing considerations, further comments will be made to pinpoint particular areas for European initiative.

PART G: BUSINESS AND MARKETING CONSIDERATIONS

In Part B of this report, we gave an overview of the Japanese market for alcoholic beverages, briefly examined the position of each of the three main EC liquor exports in the market place and summarised some of the changes in the Japanese liquor market that have impacted, in recent years, on both imports and domestic products.

In the subsequent four parts of the report, attention focussed on what have been categorised as regulatory factors; these were analysed in detail and recommendations put forward for EC action to strengthen the position of the EC imported products.

In this part of the report, we address the remaining significant issues arising in this study; we will look in rather more detail at the structure of the markets for each of the three main EC liquor exports, comment on some aspects of the performance of EC producers and marketers in this market place and finally develop recommendations for action.

Whereas the recommendations from other parts of the report should lead to public action, the outcome from this part should be a series of actions to be taken primarily by the industries themselves.

Because the issues involved differ for each product group, we examine them on a product-by-product basis.

1. Scotch Whisky

1.1 Analysis

As has been made abundantly clear in previous parts of the report, the current depressed state of Scotch whisky sales in Japan, particularly those of standard Scotch, can to a very considerable extent be traced directly to the effects of Japanese import duties and liquor tax on the price structure of the whisky market. There has also been much price instability in the market, caused by parallel imports. These issues have been dealt with in substantial detail in earlier parts.

To complete the picture, however, it is important to take account of other aspects of the decline in Scotch whisky sales and identify other factors that have contributed to this decline.

A long-term trend

The first point to note is that we are dealing with a fairly long term trend. Scotch whisky sales and market share in Japan increased steadily in the 70s, from the market opening in 1971 up to the peak in 1979. Since then, the absolute volume and the share of market have been in fairly constant decline. So the situation in Japan has, in fact, run fairly closely in parallel with the world-wide Scotch sales picture over the past 14 years.

Price instability for Scotch

There is an almost unanimous view in the trade in Tokyo and the U.K. that price instability for Scotch has been a major cause of loss of market position. Reasons for this are said to have been:

- The impact of parallel imports on the price structure of major Scotch brands.

- Exchange rate fluctuations

- Inflexible pricing from suppliers, which, among other things, has meant that advantages available from exchange rate movements have not been always achieved.

In marked contrast is the apparent ability of local makers to influence and even control the retail prices of their products through their trade influence. This issue will be examined in more detail in Part H.

The stated result of these price variations has been:

- A loss of image for Scotch, particularly in the gift and upper class bar trades.

- A major squeeze on wholesalers' and retailers' margins for standard Scotch.

- A similar squeeze on agents' margins.

- General instability and lack of confidence in the product.

Attitudes and market performance of the industry

There is a body of opinion in Japan, among agents, importers, public servants, market research companies and others, that many of the problems Scotch whisky is currently facing are attributable at least in part to failures in the industry itself. The following are the major issues that have surfaced during our study:

- For many years (probably until the early '80s), the Scotch industry is said to have made little attempt to respond to changing market needs in Japan or to tune its offering to those needs. The industry is seen as traditionally production-oriented, and is said to have failed to see problems coming up and failed to take any real corrective measures until it was hit by declining sales.

- This lack of closeness to the market has been particularly evident in the field of new product design and launch activities. In effect, nothing was done in this context specifically for the Japanese market until about 1983, when the declining sales pattern had already been in place for three or four years. Since 1983, a number of products (for example Johnny Walker Old Harmony, White Horse Extra Fine and others) have been specifically designed, developed, packaged and marketed with Japanese consumers and trade requirements in view. Sales of these products have grown strongly since their launch and are still growing now, in face of the decline affecting domestic whisky as well as standard Scotch. But it is seen by many to be a case of "too little too late" and in particular, nothing has yet been done to protect the standard Scotch position and price.

- The proliferation of brands of Scotch continues in the Japanese market. Some 200 different brands are on sale, with exporters still trying to introduce yet more to the market place. This is but part of a broader issue of industry marketing coordination, the lack of which must tend to undermine the market thrust of the Scotch whisky industry in Japan.

- In the broadest sense, the industry appears to have no marketing policy or plan for the Japanese market. The advantages of the sole agency system as it works in other markets are undoubtedly diminished in Japan by the fact that such arrangements tend to intensify the fragmentation of the industry and therefore increase the problems of putting together a coordinated marketing programme for the market. It has been said that the industry, in some ways, competes more effectively against itself than it does against its real Japanese competitors.

- As another reflection of this same issue, the industry has also made almost no investment in proper representation of its interests in Japan. The interests of Scotch whisky in Japan are in the hands of organisations that are not financially linked to the industry. Given the size of Scotch whisky's stake in Japan, this must be seen as an instance of long term market neglect, and as one of the reasons leading to the current serious difficulties.

It is argued that, given the inherent difficulties in the Japanese market, efforts and investments on the above lines could not be commercially justified and that the likely results would not adequately reward the financial risks involved. On the other hand, Japan is still, by volume, the industry's second largest export market and it is difficult to escape the conclusion that the boom growth through most of the 70's led to some complacency and that action to adjust to market changes was far too slow in coming.

Strength of the local industry

In contrast to the apparent lack of prompt coordinated effort by the Scotch whisky industry, its local competitors in Japan are extremely tightly organised. In Suntory, one is dealing with a highly organised and controlled company, which has been able to plan and carefully manage its approaches to the Japanese market. They have clearly made use of the liquor tax system to identify positions in the market and then specifically target products (including flavour, name, packaging, price) to slot into the identified market segment.

Because of their strong volume base, developed prior to 1971, they have built up an earning capacity able to support very major advertising and promotion expenditures on their special grades.

Of equal significance, they have, over many years, built up an intensive network of trade relationships and influence, that enable them effectively to dominate the distribution channels throughout Japan and in large measure to impose their will on them. One of the reasons behind this is the philosophy of Japanese business about investing long term for market share at the expense of short term profit. It is possible to do this in Japan, given the different financing structures of most major Japanese firms.

In summary, one has the impression, looking at the whisky market in Japan, of a battle between unequal forces. On the one hand, there is an industry that does not give the impression of being strongly united at home; it is represented in Japan by organisations of differing capabilities, strengths and interests and has no any substantial investment in industry representation in the market; on the other hand, there is a tightly knit local group which is able to set very specific market objectives and work consistently to their achievement.

Advertising and promotion

Because of the strūcture of the market, the domestic brands are able to exert much more total A & P weight in the market place. In 1983 and 1984 total Media Advertising spend on whisky is estimated as:

	¥ MIO
Domestic brands:	14,000
Imported brands:	2,500

Over 70% of the domestic brand spend is on Special grade whiskies, even though these represent only 50% of total volume.

By individual brands, again, the total weight of spend is far greater on domestic brands.

However, the spend per unit volume and therefore the impact on profit margin is far less for the domestic brands. Taking the above expenditure estimates against tax cleared sales for 1983, the result is as follows:

	¥/litre	
	average all grades	special grades only
Domestic	39.0	56.5
Imported	125.6	125.6

1.2 Suggested Directions for Future Action

There is no doubt that the future of Scotch whisky in the Japanese market will be substantially determined by the success of EC interests in improving the regulatory climate surrounding the activities of the Scotch industry in Japan. However, it is our view that, unless the industry is also prepared to be more aggressive, innovative and flexible in its future work in Japan, there is a very real risk that the potential advantages from improvements on the regulatory front could be frittered away.

It is clearly not within the bounds of this study for the consultants to undertake any specific, detailed suggestions for action by the industry. However, based on our experience and on the information generated during this study, there are some observations that need to be made.

Product Development

One of the strongest criticisms leveled against the industry in the past was its failure until quite recently to take any strong action towards tailoring its products for Japanese consumer needs.

During the last two years or so, there has been a change and some valuable work has been done in developing new products which, in terms of strength and flavour, packaging and presentation, pricing and other aspects of the marketing mix, have been carefully researched and methodically developed to fit a niche in the market place. Even though the volumes are still small, these new products currently represent the only area of substantial growth in Scotch sales in Japan.

Much more needs to be done and of course, if there are changes in the tariff structure to the advantage of Scotch, the opportunities for innovative work in this field will be increased enormously. The key thrust would need to be into the large take home market, by far the major volume segment in Japan and one that has traditionally never been really penetrated by Scotch whisky. Such an effort will involve significant investments in market research, product development, package design and A & P, as has been the case with the other new products recently launched. This sort of willingness to undertake long term marketing investment programmes, with the returns not available except in time-frames much longer than those that are usual in other markets, has to be accepted as one of the normal risks involved in market development in Japan.

As has been indicated elsewhere, one significant side benefit of product development programmes along these lines is that the products that result are immune from the problem of parallel imports. This is thus another way in which this form of activity will serve to build long term strength for Scotch whisky in the market.

Brand Coordination

We have commented earlier on the existence in Japan of some 200 or so separate brands of Scotch whisky. In a market where consumers tend to be brand conscious and where the name of the marketing game is very much one of building franchises round strong brands, the presence here of so many brands of Scotch can only be counter-productive to the total performance of the industry.

Given the way the industry is organised, it is recognised that to exercise control is not easy. All that can be done is to pose the problem to the industry: your competitors in Japan, despite their current difficulties, have been adept at devising a structure for the Japanese whisky market and positioning a range of products designed to appeal to specific consumer groups at specific price levels. If the Scotch whisky industry is to recover a worthwhile position in this market, it needs to find some way to do just this.

Industry Structure and Representation in Japan

The problem of fragmentation of brands is, in our opinion, just one facet of a general problem of fragmented and uncoordinated activities by the industry in the Japanese market.

Given the structure of the industry in the U.K. and the related structure of its agency arrangements in Japan, this situation is not easy to change. The consultants are obviously in no position to make any comments on the structure of the industry in the U.K.; however, from our work on this project in Japan, a number of possible options for future change have emerged which are worthy of serious consideration.

The overall purposes would be:

- To provide the industry with a means for managing and coordinating its efforts in Japan, in the whole field of product marketing.

- To reduce the existing fragmentation of effort and provide a basis for more coordinated overall marketing planning.

To this end, some possible lines of action to be considered are:

- Locating in Japan an experienced industry man with strong marketing capabilities, with the task of developing and coordinating the marketing efforts of the various supplier and their various agents and distributors. This, in our view, represents the minimum investment that the industry should make in this market.

- Making a significant investment in the marketing and distribution of key products in Japan. This could be done in all sorts of ways: by setting up a new marketing and distribution company here, to operate industry-wide, if that were achievable or, if not, as the marketing arm of the Distillers Group; or by forming joint venture operations, maybe in conjunction with the agents of major Scotch whisky brands (such as Caldbeck, Jardine Matheson,) etc.

Given the scope of this project, the consultants can do no more than pose these questions to the leading members of the industry. The only additional comment we would make is that in our experience of working with foreign organisations marketing their products in Japan, there is usually a very direct relationship between the level of commitment and investment that the suppliers make in the Japanese market, and their long term succcess and profitability here. In view of the current state of the Scotch whisky industry in Japan, the potential for making more of this market and the down-side risks if major changes are not undertaken, we believe that the industry must very carefully assess alternative ways of establishing a strong marketing presence of its own in Japan and take firm action to ensure that such a presence is achieved.

If positive action is not taken in the areas of product development and the re-organisation of the industry's presence in Japan, it is our opinion that, no matter what is achieved on the regulatory front, these opportunities will not be translated into maximum increased sales; and at worst, the result could well be that standard Scotch will continue to be squeezed out of the Japanese market, leaving only a continuing, small volume through relatively profitable premium market for gifts and a growing market for intermediate Scotches.

2. Wine

2.1 Domestic Competition

Before looking at the marketing issues facing European wines in Japan, it would be useful briefly to comment on the nature and structure of the Japanese domestic wine industry, in order to give a clearer picture of the nature of the domestic competition.

Key factors to note are the following:

- Japan's capacity to produce grapes is limited by shortage of available land; the scope for future expansion of local grape production is severely restricted.

- Costs of local grape production are high, up to eight times higher than in the EC and U.S.

- Few of the vineyards in Japan produce grapes specifically for wine, much of which is from table grapes. Only about 7% of total Japanese grape production is wine grapes.

- In consequence, Japanese wineries rely heavily on imported bulk and on wine made in Japan from imported grape must.

- According to trade estimates, Japanese wine production in 1984 was made up of the following materials:

  - 39% from imported bulk
  - 37% from grape must, raisins and other ingredients
  - 24% wine from domestic grapes

- Taking into account the 27% of total wine supply into the market that comes from bottled imports, domestic grapes contribute less than 18% of the total.

- The domestic wine industry is highly concentrated. Of approximately 200 active wineries in Japan in 1983, three large ones, Mercian, Suntory and Mann's supply about 2/3 of local production, while the top ten firms supply about 90%.

2.2 Segments of the Wine Market

Trade estimates indicate that about 60% of total wine volume sold in Japan is for home consumption. Bars and restaurants and other institutional outlets cover about 35%, while most of the balance is gift pack sales. The profile of imported wines is very different however; based on trade estimates, some 40% of imported wine goes through restaurants, 22% in gift packs and only 38% for the in-home trade. On these figures, the poor penetration of imports in the take-home segment is significant, the share in this segment being only around 15% compared with imports' overall market share of 27%.

In terms of price breaks, there are two fairly clearly defined segments in the market for table wines in Japan, as follows:

The lower price segment, from ¥1,500 per litre downwards, is primarily the take-home segment, serviced through supermarkets and local liquor shops. As noted the major Japanese wine makers are focused heavily on this end of the market.

Imported wines are also competing strongly in the upper end of this sector, (¥1,200 - 1,500) keeping below the ad valorem tax barrier. These include the bulk of the German wines, particularly whites, significant volumes of Italian wine and some portion of the French trade.

The upper price segment, that is to say retailing in the stores at ¥2,000 and upwards, is in fact primarily the high class restaurant trade. This business is strongly in the hands of imported European table wines, particularly from France.

In terms of future total market growth, projections for both segments look most encouraging. Some of the reasons to support this are:

- The current very low per capita consumption of wine in Japan compared with most developed markets overseas.

- The growing affluence of young single women who represent a major market for wine.

- The healthful image that wine enjoys.

- A general switch in consumer preferences towards lighter foods and beverages.

- Changing patterns of drinking. People are more and more enjoying alcoholic beverages with their food rather than drinking for its own sake.

However, the significant volume growth, in absolute terms, will undoubtedly be in the lower priced take-home segment, so to maintain market share and keep pace with this growth, European wines will have to develop their product range and their marketing approach very closely tailored to this segment's needs.

This segment will increasingly be dominated by younger drinkers, including females; so marketing appeals addressed to these groups and products priced and packaged to suit their tastes and their pockets will be vitally important.

In this context, the thrust of the Japanese makers is already clear. According to local winery estimates, almost 70 % of domestic wine sales are shared between 1.8 litre bottles (between ¥1,100 and ¥1,400 per bottle) and standard bottles priced at just above ¥1,000.

2.3 Brand Marketing

If EC wines are to maintain or increase their share of the Japanese wine market and in particular of the vital low priced take-home segment, brand marketing programmes will have to be introduced much more widely than is the case at present. There are various reasons for this:

- The Japanese consumer are brand-oriented. They respond most readily to a heavily promoted umbrella brand name, for which they develop a high level of awareness and confidence.

- The Japanese wine makers, recognising this trend, have worked hard to develop brands and the four major ones, at least, are now well recognised by significant numbers of Japanese consumers.

- In contrast to this, most European wines are sold under a great multiplicity of names, representing areas in Europe, names of estates, names of exporters, etc. For the Japanese consumer, largely ignorant of the structure of the European wine industry, this product presentation is bewildering, particularly as much of the information provided on the labels is in a European language. As we saw previously in Part F, there is research evidence to indicate that Japanese consumers, faced by this array of often incomprehensible European offerings, are turning to the easy-to-buy alternative of a heavily advertised Japanese brand.

2.4 Recommendations for Action

Following on from the comments made above, the key area in which decisive European action on wine will be needed is to develop effective brand marketing programmes. In terms of activities to be carried out, such a programme would require:

- On-going market research and monitoring, to ensure that the European brands can be progressively tailored, packaged, priced and promoted to address the needs of the key segments in the Japanese market.

- Appropriate product development and marketing programmes to implement the research findings.

- Special arrangements for the blending, bottling and packaging of the branded product, presumably in Europe in the initial stages. Given the structure of the European wine industry, this will require different approaches to wine marketing from those that have been traditionally used in the past.

- Strong initiatives in the packaging field, in particular to cater for the low price take-home market segment. Various innovatory forms of packaging have been launched in other markets (e.g. Australia) and some work is already been done in this direction in Japan. In this context, the likely growing role of young consumers in the market will need to be addressed.

- Finally, substantial investments in advertising and promotion campaigns to create awareness of the European brands and build up their franchise with Japanese consumers.

The overall goal would be to build brands and an awareness of them in the market place. Some recent innovations (such as the Vantage and other ranges recently launched) are indications of what is needed on a much larger scale.

If the Japanese market is to be effectively tackled on these lines, major problems of industry organisation and distribution arrangements will need to be addressed. The major difficulties will be:

- The highly fragmented nature of the European wine industry, where the exporters are either individual growers, co-operatives or export traders.

- The general lack of marketing sophistication of many of the producing organisations in Europe. For many of them, the concepts of brand marketing discussed above will be almost totally foreign.

- The related fragmentation of the distribution arrangements in Japan. The current pattern is for each exporter in Europe, large or small, to make his own agency/distribution arrangements with importers, wholesalers or local manufacturers in Japan. There are scores of local organisations currently handling various European wines and we understand that more are being added to the list almost daily.

To continue along these lines will never resolve the organisational problems, it will only compound them. Fresh initiatives are clearly necessary.

To be more specific, an overall organisation plan on the following lines should be carefully considered:

- For the upper end of the wine market, the higher priced and higher quality wines destined primarily for the restaurant trade, the existing marketing arrangements are appropriate. Consumers in these segments are by and large knowledgeable wine buyers, able to handle the complexities of the presentation of European wines in their existing form.

- Similarly, at the upper end of the take-home market (prices around ¥1,500 per bottle) the existing methods should continue to prove adequate.

- However, in the area where the real growth is likely, i.e. take-home wines priced between ¥800 and ¥1,200 per bottle, a brand marketing approach and new organisational arrangements will become essential.

In this latter key segment, the problem is to identify organisations of sufficient size and strength to be able to make the investments and to have the distribution muscle necessary for the initiation of strong brand marketing programmes. As indicated, some useful initiatives are being taken by one or two agents but these are still on a very modest scale.

What is really needed is to set up and finance marketing/distribution organisations, dedicated to the development of branded European wines in Japan and possessing the resources to address the task on a large enough scale.

Marketing organisations of this kind could conceivably be set up and funded at various possible levels:

- At regional level (e.g. Bordeaux, Burgundy, Mosel, etc.

- At national level

- At EC level

Setting up these kinds of structures will be far from easy. As we see it, the initial thrust should come from the EC itself which should aim:

- First, to create a real awareness among the leading organisations in the European wine industry that there is in Japan a potentially large opportunity, which will require new patterns of wine industry organisation if it is to be exploited.

- To initiate discussions, preferably at regional level or maybe at national or European level, between supplier groups and existing distribution companies in Japan who have an understanding of the marketing concepts involved and some motivation to participate in joint marketing projects.

In more detail, one specific field where new EC initiatives will be needed is that of marketing communications: sales promotion, public relations and similar activities. Objectives for such programmes would be:

- To encourage greater wine consumption in Japan and thus increase the size of the total wine market

- To maintain or increase the EC share of this expanding market

- To increase consumer awareness and knowledge of European wines: recognition of the main EC producing countries and regions, awareness of the superior qualities and fine traditions of European wines, awareness of the major brands of EC wines being marketed in Japan, etc. etc.

This promotional effort should support both the top quality wines being sold into the restaurant trade and also the brands designed to penetrate the more price-conscious take-home market.

All this will require larger budgets and a stronger organisation that exist to-day. To back up the A & P spend that the marketers of individual brands would contribute, strong consideration must be given to setting up supporting campaigns on a broader basis. These could operate at regional or country level or perhaps for the EC industry overall. Once the overall organisational base for this is laid down, objectives, budgets and promotional programmes can be developed and implemented.

In the longer term, another option that may have to be addressed is that of setting up in Japan, by European interests, of wine bottling operations. Currently, this is seen by people in the industry in Japan as a very long shot. There are various reasons for this view:

- Indications are that from a regulatory point of view, setting up such an operation in Japan may not be easy. Applications would apparently be dealt with on a "case by case" basis, that is to say with no rules or guidelines.

- Volumes of individual brands would have to be increased many times above their present levels for local blending and bottling to be anything other than grossly uneconomic.

- There is likely to be significant and entrenched opposition to any such move from existing local wine makers.

- Costs of all aspects of wine making in Japan: prices of bottles, corks and labels, bottling operations are all inherently highly costly activities.

- In any case, it is asked what is the point of setting up in Japan an operation that is unlikely to be profitable, for the purpose of transferring added value and jobs from Europe to Japan?

However, despite these major difficulties, the option is one that should not totally discarded for the longer term. If, for example, no progress is made in winning concessions from the Japanese authorities on the duty and tax fronts, the only way open to the European industry to really grow with the market may well be that of blending and bottling locally, inside the duty barriers.

In any event, such a development is only conceivable at all if a policy of brand marketing from Europe has been first established, and sales of individual brands developed up to a level in Japan that might support a local bottling operation.

3. Brandy

3.1 The Segments of the Cognac Market in Japan

Duty Free sales are a significant (estimated 14%) segment of total cognac volume in Japan. Within domestic sales, the active segments are the bar trade, estimated at approaching 70% of total cognac volume and the gift trade which absorbs most of the remaining volume. The take-home trade is virtually non-existent. As the bar trade tends to be at the high-class end of the market, the cognac ranges have been able to maintain their position, because the distributors have reasonably good access to these key market segments and do not face price competition as they do in the take-home area.

There is, however, some concern at the potential future status of this high-class bar trade. It is seen by many as a declining segment, with corporate and fiscal pressure on extravagant expense-account spending. There are also real problems, given the structure of this sector, in building any lasting brand loyalty.

3.2 Advertising and Promotion

The recent pattern of brandy media advertisng has been as follows:

	¥ MIO 1983	¥ MIO 1984
Domestic	1,300	1,550
%	36	40
Imported	2,300	2,350
%	64	60

Thus the recent level of spending on imported brands has been roughly stable, while the domestic spend, in absolute value and as a %, has increased. There was a major jump in the total spend in 1983 compared with 1982, with most of the increase on imported cognac brands.

For imported brands, the A & P level relates closely to the brand's share of market. Similarly, domestic expenditure is Suntory-dominated, following their market share of over 70%.

3.3 Industry Cohesion and Marketing Effectiveness

From our discussions to date, we have formed the impression of the French brandy industry as being an old and traditional one, smaller in size than the Scotch whisky industry, and in general more cohesive and in some ways more effective as an industry. This is reflected in the effective positioning and marketing of a small number of well known brands in Japan, with a generally high level of marketing capability shown in the market place. Remy was originally positioned by Dodwell and is now handled by the Sanraku-Remy joint venture; Jardine Matheson have been responsible for the successful marketing of Hennessy.

3.4 Suggestions for Future Action

As indicated previously, there is a quite impressive level of professionalism about the present efforts to market cognac in Japan. However, on the certain assumption that local competition will intensify, consideration should also be given to the strengthening of the European effort, to make sure that market shares for cognac are at least maintained and that, if possible, the position of grape brandy is protected.

This will involve activity in product development, based on proper market research and taking intiatives to upgrade all aspects, particularly packaging, of the presentation of the product to Japanese consumers.

One area of possible concern is that of advertising and promotional spending, where, as we have seen, the level and share of Japanese industry expenditures has risen in the last year or so. This may well be a portent of a significant threat to the brandy import trade in future, particularly if Suntory continue to seek diversification of their spirits business in face of a continuing decline in whisky sales.

PART H: OTHER ISSUES

A key part of the overall strategy of this project, in the consultants' opinion, has been to focus attention on a few key issues that will have a significant bearing on the performance of EC liquors in the Japanese market. It has been our concern from the outset that if corrective action is undertaken on too many fronts, there will be a fragmentation of European effort and the overall result is likely to be disappointing.

In structuring this report, we have focussed, in Parts C - F above, on the agreed key issues in the general regulatory area. In Part G, we addressed a series of equally important issues under the heading of business and marketing considerations for attention mainly by the EC liquor industry itself.

In this final Part, we are providing brief comments on the results of our researches into a number of other issues that have surfaced in the course of our work. In our opinion, these are not top priority issues in terms of scope for European action; they should, therefore, not be allowed to distract European attention and effort from the main thrust.

1. Retail Pricing of Liquors

In some of our interviews with European interests, it was suggested that local distillers seem to be able to maintain "fixed" retail prices for some of their products, given the strength of their grip on the domestic distribution system.

Imported products are unable, of course, to do this (in fact, the fixing of retail prices is in any case illegal), so overall this situation, if it is correctly described, would clearly work to the local distillers' benefit.

Our interviews with wholesale and retail traders has thrown some more light on the subject. From these interviews, it is clear that the powerful local brand manufacturers, by various means, are in effect able to ensure stability of retail prices in those cases where they desire such stability. Various verbal sanctions are available and apparently employed (e.g. reduction of supply, removal of incentives, disallowance of discounts, etc. etc.) which the retailer finds it difficult to ignore coming from the manufacturer of a product in major consumer demand.

From our discussions with traders involved in other product areas, the same comments have been received. Manufacturers of major brands, for example in fields such as cosmetics, soap and other fast moving consumer goods, appear able, by various means, to maintain reasonable stability of selected key brands at retail level.

During our interview with the Fair Trade Commission, we discussed the question of retail pricing. The Commission's attitude is quite clear: retail price maintenance is prohibited by the Anti-monopoly Act, and liquor products are not an exception under this act. Manufacturers are entitled to indicate desired retail prices for their products but these indications are not binding and any attempts by manufacturers to enforce fixed retail prices are an offence under the act. For example, if manufacturers threatened to discontinue supply, or to increase prices (by whatever means), such actions would be an infringement.

However, according to the information provided during our interview, no cases of any action being taken by the Commission under this regulation could be recalled; clearly, the problem is one of obtaining any valid evidence of such infringements as may occur.

In our opinion, this is not an issue to be pursued by European liquor interests, even though the apparent price stability of certain domestic brands, compared with the price instability, for example, of major Scotch whisky brands, is galling. There does not seem to be any practical way of pursuing this issue in concrete terms.

2. Japanese Distribution System

There are many aspects of the Japanese distribution system that have been raised with us during our study, as is inevitable in examining the issues facing any imported goods coming into Japan.

We do not, in this report, propose to comment in any way on the basic nature or structure of the Japanese distribution system. This is well known to those involved in the industry; the system exists and functions for many reasons that are basic to the Japanese trade and economy and the role of the importer can only be to learn to live with and make use of the system.

However, there is one specific aspect that has been investigated in some detail. This relates to the procedures used in Japan for the awarding of retail liquor licenses to retail stores.

These procedures, operated by the local tax offices, in addition to being somewhat complicated, are said to work to the disadvantage of the large supermarkets.

These supermarkets are apparently regarded as strong competitors of the small local liquor shops; they are catering for the same take-home business and the supermarkets, with their buying power, are able to cut prices and threaten the business of the small stores.

Department stores, on the other hand, regarded as mainly in the gift business for liquor, are not seen to compete so strongly with the small shops.

Strong pressure is apparently exerted by the liquor stores associations throughout Japan to restrict the allocation of liquor licenses to large supermarkets. In consequence, it is estimated that only about 7% of supermarkets across Japan hold liquor licenses, compared with almost 100% of department stores. The growth in supermarket liquor licenses is very slow and it can take between 5 to 10 years for an application from a supermarket to be processed.

This would work to the disadvantage of the imported product, which supermarkets are capable of handling in significant volume to service the important take-home business. For this segment, they are the key outlet for imports; department store trade is largely a gift trade, while the local liquor stores still deal mainly in domestic beer, whisky and sake.

So this is an issue of some substance and it would seem appropriate for EC interests to lend their support to the supermarket operators in their requests for liberalisation of the retail liquor license system. This should address not only the question of license allocation to supermarkets but also the de-regulation of licensing arrangements for special import promotions, fairs, etc.

3. Product Definition

European interests have drawn the consultants' attention to the ways in which certain liquors are defined in Japanese practice and have suggested that these definitions and the resulting liquor tax charges may be working to European disadvantage.

The most frequently mentioned case relates to the Japanese definition of whisky.

Article 3 (9) (a-c) of the Liquor Tax Law defines three ways in which a liquor can qualify to be called whisky. The details are set out in Appendix 2.1 and in a paper "Notes on the definition of whisky in Japan", in Appendix 9.3 of this report.

The definitions are regarded by the Scotch whisky interests as excessively loose and subject to misunderstanding, particularly with the problems of translation from Japanese into English. The definitions admit as whisky, products with minute amounts of malt or grain whisky, which would not be classified as whisky in any major market elsewhere in the world. (For comparison, we have also included in Appendix 9.1 definitions of whisky used in other markets.)

This purportedly loose Japanese definition, according to certain views in the trade, has been used as the basis for developing a totally distorted whisky market in Japan, with products on the market labelled whisky which other markets would not admit as such.

These views could well be correct. Certainly, the nature of the range of whisky products marketed in Japan differs widely from those in other countries and this can largely be attributed to the way whisky has been defined in this country, to the related labelling practices and also eventually to the structure of the liquor tax for whisky.

However, we see no value at this stage in attempting any regulatory actions to redress this situation. For one thing, such action would be far too late; it should have been initiated years ago. By now, with many years of market development, consumer tastes and understandings have developed in this market on quite unique lines and are now deeply entrenched and established. Japanese whisky drinkers have their own very clear view, from a consumption viewpoint, of what they mean by whisky and no amount of redefinition of the product is likely to change these habits. No would there be likely to be any noticeable change in consumption habits if changes were made, for example, in the requirements for listing of ingredients in domestic whiskies.

Given the existence of other issues that can be tackled positively and that are capable of making major changes to EC liquor exports, our view would be to regard the issue of product definitions as a low priority item for regulatory action. This is not to say that strong pressure should not be maintained for clearer labelling of whisky; and in addition, there are undoubtedly other avenues in the field of publicity, that are more likely to lead to positive results.

4. Bulk Exports

In all three of the main product areas, bulk imports into Japan have been growing faster than bottled:

- Over the period 1979 to 1984, imports of bulk whisky increased by 11% while imports of bottled declined by 31%. The bulk share of market went from 44% to 55%.

- In the case of brandy over the same period, bulk imports doubled, bottled imports went up 27% and the bulk share went from 28% to 38%.

- As for wine, bulk imports again doubled while bottled imports increased by 66%. In this case the bulk share went up marginally from 53% to 57%.

In the case of wine, most of the bulk imports (about 85% in 1984) came from Eastern European and South American countries, in the former case enjoying the very low preferential import duty rate. So in this instance, the issue for European interests is one of relative import duties and this has been addressed in Part D of the report.

In the case of whisky, some 87% of the bulk imports into Japan come from the U.K., i.e. from the Scotch whisky industry itself; and a very similar percentage of bulk imports of brandy into Japan comes from French sources.

This trade is a source of concern to firms handling the imported bottled product and also to some of the manufacturers in U.K. and France. However, in both industries, there appears to have been no industry-wide policy regarding bulk shipments and in the case of whisky, the Japanese market, like other overseas markets, continues to follow the trend towards the dominance of locally blended and bottled whiskies.

Similarly, we understand that in France there is currently no attempt to develop a coordinated policy among the brandy makers about supplies of bulk to Japanese makers, there are apparently a number of small shippers in France active in the trade.

In the industries, there are clearly sharply divided views. Those who are concentrating on bottled business regard the sale of bulk as a sell-out of the genuine European industry interest to its Japanese competitors. Those firms heavily involved in the bulk trade are presumably taking commercial decisions based on their view of the objectives and interests of their individual firms.

The impression we have formed from our investigations is that there appears to be no realistic way of changing this situation; certainly in the case of Scotch whisky industry, the opposing positions appear to be irreconcilable. The brandy industry, being smaller and somewhat more homogeneous, may be better placed to decide on an industry policy but the evidence to date is that this has not yet occurred.

In our view, this will be an area in which individual firms will continue to take individual commercial decisions based on their view of their own corporate interests. Attempts to reconcile these views and to set up and control any form of industry policy on bulk shipments, seem likely to fail.

5. Duty-Free Allowances

There are certain to be pressures in the near future from domestic manufacturers for reduction of the existing duty free allowance of three bottles of alcoholic drinks brought into Japan by travellers. In fact, a request to this effect has been presented already in the Statement of Demands Concerning Liquor Tax and Other Matters prepared by the Japan Spirits and Liquor Makers Association dated September 29th 1984 (Demand VII).

According to trade estimates, the quantities involved are substantial: about 20% of the current regular imports of Scotch whisky and 10% for brandy. The loss of this business would be serious for the industries concerned.

The request for change from the domestic manufacturers is, of course, based on the fact that duty free allowances in the U.S. and Canada are around 1 litre per person, while those in major EC countries can, depending upon individual traveller choice, be more restrictive for some products than are the Japanese rules.

The strong arguments on the other side of the case, particularly potent in today's atmosphere of international trade friction, are that at a time when the Japanese Government is making efforts, under strong overseas pressure, to liberalise and open its markets for imported goods and services, any move to reduce the duty free allowance of alcoholic liquors would be a very visible step in the reverse direction and one that would undoubtedly earn a great deal of ill-will among many of Japan's major overseas trading partners.