Political Strategy in the (Non)Use of Preferential Trade Agreements

Shunsuke Sato[1] and Kristin Vekasi[2]

Abstract:

Dispute settlement mechanisms (DSMs) are the key to enforcing international trade commitments in preferential trade agreements (PTAs) and a linchpin of effective trade legalization (Zangl 2008). In addition to market access, access to high-quality DSMs is a key reason countries spend considerable time and resources negotiating PTAs. Building on the work of Davis and Shirato (2007) we analyze the case of Japan, where a DSM has never been invoked despite the presence of numerous potential disputes, many quite costly for Japanese firms. Logit analysis of an original dataset including litigated and potential trade disputes from 1995-2016 finds that controlling for economic and political factors the presence of a PTA in fact decreases chances of adjudication. The effect is particularly strong for Southeast Asian countries, where Japan is attempting to nurture stronger political alliances. A close case study of Japan's negotiations with Indonesia over automobile tariffs demonstrates Japan concern that DSM use could cause political friction, and that official adjudication of trade disputes takes a back seat to geopolitical concerns. Legalization of trade and institutional design (e.g. Kahler 2000; Allee and Elsig 2016) may be the secondary story; costly bargaining builds alliances not legal recourse for economic disputes.

Introduction

Regional trading agreements (RTAs) have been increasing around the world: as of February 1, 2016, the World Trade Organization (WTO) noted 635 throughout the world, of which 423 are in effect and 14 involve Japan (WTO 2016). Negotiating these agreements is a costly and time-consuming process. The average time to negotiate one is almost three years (33 months), ranging from a quick year for the agreement with Brunei to just over seven and a half years for the Japan-Australia RTA. In addition, the Japanese negotiating team consists of between 60 to 100 people from the Ministries of Economy, Trade, and Industry, Foreign Affairs, Agriculture, Finance, and the Fair Trade Commission. Negotiations also sometimes stall indefinitely; there is no guarantee that their efforts will pay. While the Trans-Pacific Partnership's fate after the 2016 US election is the most dramatic example, Japan also has stalled negotiations with the Gulf

[1] Masters in Global Policy, School of Policy and International Affairs, University of Maine.
[2] Assistant Professor, Department of Political Science and School of Policy and International Affairs, University of Maine. kristin.vekasi@maine.edu.

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Cooperation Council (after almost 10 years of negotiation) and South Korea (after almost 13 years of negotiations). RTAs can also incur political costs for leaders, who anger domestic constituencies that oppose liberalization.

Economically, RTAs work to lower tariffs and non-tariff barriers to the mutual advantage of members; they also increase the legalization of trade through the creation of dispute settlement mechanisms (DSMs). These institutions provide non-politicized recourse to countries who believe they suffer from trade discrimination. However, despite the increase in Japan's RTAs, the usage of DSMs in trade agreements has not proportionally increased. Japan has not formally participated in one single RTA dispute settlement procedure despite the existence of multiple complaints covered only by the preferential conditions in these bilateral agreements.

An example from the Indonesia-Japan automobile trade illustrates: after a little over two years of negotiations, Indonesia and Japan signed an RTA (including provisions for a DSM) in 2007, which included provisions for a DSM. The agreement stipulated that Indonesia would phase out its automobile tariffs by 2014, but Indonesia failed to do so. Indonesia has thus been violating the Japan-Indonesia Economic Partnership Agreement (JIEPA) by overcharging import tariffs on Japanese automobiles since that year. According to news accounts, it seems that Indonesia is trying to protect local companies that collaborate with foreign companies. Japan has held multiple Ministerial-level meetings with Indonesia to resolve this problem to no avail (Mainichi Shimbun 2015). Japan has the option to use the JIEPA's DSM but has not exercised that right and does not appear to be poised to do so in the future. This behavior leads us to ask: given the resources invested in negotiations of high-quality trade institutions, why are they not utilized when it would be in Japan's economic interest to do so? More broadly, when does Japan choose to litigate and when does it refrain from doing so?

This paper seeks to understand this puzzling non-use of the established institutional mechanisms. Using quantitative analysis and an in-depth case study of Japanese disputes with Southeast Asian neighbors, our analysis reveals both geopolitical and institutional causes. We find that Japan is hesitant to use DSMs in regions with nascent and important political alliances, particularly Southeast Asia. At the same time,

the institutional design of Japan's RTAs lacks the features of DSMs that could effectively depoliticize trade issues.

In the WTO, as of April 1, 2016, more than 500 cases have been filed (WTO 2016),[3] but the use of most RTA DSMs is quite limited (Chase et al. 2013, Jung 2013). As RTAs give signatory states more preferable trade terms than larger international organizations such as the WTO, the limited use of RTA DSMs is startling: states are not taking full advantage of the beneficial trade agreements that they invested considerable resources in negotiating. Limited use of these legal institutions implies a systematic reason why RTA DSMs are not the preferred method to resolve the conflicts that inevitably rise within international trade. Japan, in fact, has not used an RTA DSM to resolve a single dispute, despite the presence of many potential cases such as the automobile tariff dispute with Indonesia.

While some argue that this outcome – underuse of institutions – is seemly indicative of a weakly institutionalized Asia-Pacific compared to other regions. One of those arguments says that economic institutionalization has proceeded more deeply but security collaboration has been very weak. Compared with Europe where economic communities and organizations like NATO link security and economics, in the Asia-Pacific context, while economic institutions and economic cooperation has been increasing over the last two decades, security cooperation has not proceeded apace. However, the evidence presented in this paper demonstrates that while institutionalization might be proceeding the legal mechanisms embedded in those institutions are not functioning as states would like them too. This argument, therefore, cast doubt on the notion that economic institutionalization has been strengthening. In the paper's conclusion, we make recommendations for how instant economic institutions in the Asia-Pacific could be further formalized and lead to deepening institutionalization in the region.

The paper proceeds as follows. After reviewing the literature on the initiation of trade disputes and Japan's use of the WTO dispute settlement mechanism, we analyze Japan's DSM use using a unique dataset of both litigated disputes and potential but

[3] WTO, Chronological list of disputes cases. Available: https://www.wto.org/english/tratop_e/dispu_e/dispu_status_e.htm.

unlitigated disputes from 1995-2016. We use the results of our analysis to closely examine specific cases of Japanese trade disputes with countries in Southeast Asia with which Japan has negotiated RTAs. The paper concludes with a discussion of how the increasing institutionalization of trade in Asia is more of a reaction to China's increased political and economic clout, and not a sign of increasing legalization. We close with discussions of how to design trade institutions that will both provide the political benefits and offer legal recourse to wronged parties.

Trade Institutions and Dispute Settlement Mechanisms

In the past decades, after the creation of the World Trade Organization (WTO) in 1995, and rapid increase in regional trade agreements (RTAs), trade has been institutionalized and legalized to an extent never seen before (Goldstein and Martin 2000, Rosendorff 2005, Hillman 2009, Mansfield and Pevehouse 2013). One of the strongest indicators of increased legalization (and most important indicators of deepened legalization within the WTO) are formalized dispute settlement mechanisms, wherein trade disputes can be settled through third party, neutral arbiters. If the obligations of trade agreements cannot be enforced when one of signatories to a trade agreement fails to comply with the obligations, the practical value of the commitment of trade agreements decreases. Concurrent with the creation of the WTO, RTAs also began to develop highly formalized DSMs (Froese 2014). Settling disputes in a timely and structured manner helps to prevent the detrimental effects of unresolved international trade conflicts and to mitigate the imbalances between stronger and weaker players; disputes are settled on the basis of rules rather than allowing political power to determine the outcome.

International trade rules can be effective when they are properly applied, and the highly legalized and institutionalized DSMs are important ways to enforce obligations committed in the international trade rules among signatory countries. Legally effective DSMs can remove the uncertainty of enforcement within international trade agreements, overcoming a critical barrier of international cooperation (Kono 2007, Davis 2012, Jo and Namgung 2012). A system that provides a third party to judge and punish noncompliance via a formalized DSM provides an automatic enforcement mechanism. By explicitly embodying a credible threat of retaliation or reciprocal action or the ability to impose

substantial costs on a party guilty of noncompliance, trade agreements become self-enforcing (Yarbrough and Yarbrough 1986). Moreover, DSMs within RTAs have been shown to increase volume of trade (see Jo and Namgung 2012: 1042).

While there is broad agreement that the WTO DSM has generally provided an effective mechanism through which WTO Members are able to resolve disputes (Iida 2004, Davey 2005, Davis 2012), some debate does exist about the effectives of DSMs in trade agreements (Bello 1996, Rosendorff 2005, Zangl et al. 2011). The WTO DSM is also "the jewel of the crown" and has superior institutional capacity and design compared to dispute settlement mechanisms in other trade agreements (Lewis and Bossche 2013, Kalderimis 2013). In the case of the WTO DSM, procedures begin with a complaint stating the legal basis for the complaint by one or more countries against another, followed by consultation between the countries, a WTO panel report on the issue, and potentially trade sanctions against one of the countries (Davis 2012). These elements strengthen the ability of the WTO DSM to effectively litigate and enforce disputes.

Given the general efficacy of the WTO DSM, states have been quick to imitate the institutional design when negotiating bilateral or regional trade agreements. Froese (2014) outlines reasons why states which are heavily involved in the WTO DSM may wish to develop similar mechanisms in RTAs: to demonstrate confidence in the institution, to protect WTO-extra and WTO-plus agreements, and to express support for an approach that privileges judicial independence. On the other hand, contents of RTA DSMs vary widely across agreements (Chase et al. 2013). For example, some RTAs have provisions of establishing standing tribunals or courts, whereas others use ad hoc tribunals for resolving disputes. There is also considerable variety across features associated with timely resolutions, selection of panelists, forum choice, and sanctions (Allee and Elsig 2016).

Not all RTAs adopt the same institutional structures as the WTO for reasons ranging from fewer trade conflicts (Li 2014) to the availability of the WTO as an alternative (Jung 2013, Chase et al. 2014) to regional (Jung 2013, Allee and Elsig 2016) or region type (Busch 2007) differences. The RTA DSM process can range from a diplomatic, power-based form of resolution, to a more judicial, rules-based procedures (Lewis and Bossche 2013). For example, the Association of Southeast Asian Nations

(ASEAN) Free Trade Area (AFTA) DSM includes diplomatic elements and therefore does not function as a neutral and professional arbitration mechanism as well as the WTO (Puig and Tat 2015). Some RTAs such as, the India-Nepal Free Trade Agreement (FTA), adopt political consultations to reduce trade tensions instead of adopting third party adjudication while others like the North American Free Trade Agreement (NAFTA) have institutionalized arbitration systems (Jo and Namgung 2012). RTA DSMs that lack third party adjudication system are susceptible to trade disputes being decided by political power rather than more neutral trade rules.

The potential use of a DSM may work to solve a dispute in the negotiation stages. Once the DSM procedures start, it can be very costly for respondent countries to effectively litigate the case. As a result, respondent countries might want to avoid going to the DSM stage and subsequently may cease to violate the rules, making the DSM an effective deterrent. However, considering the important roles of the RTA DSMs to enforce obligations, the limited use of the RTA DSMs indicates current RTAs may allow countries to derogate from trade rules limiting the deterrence effect. Given the proliferation of RTAs, and continued regionalization of the international economy, the lack of formal legalization within RTAs is a serious challenge to the international trade system supported by RTA proliferation.

When States Litigate

Despite the increased legalization and binding nature of the DSMs, states still choose at times not to litigate in the presence of a dispute. A country will use the DSM when the benefits of initiating or joining a dispute settlement procedure are higher than the costs of doing so (Bown 2005, Davis 2012). Adjudication costs can potentially include administrative burdens, the setting of legal precedent, and diplomatic costs (Davis 2012). At least in the context WTO, however, when exporters have a sufficiently large share of the market to recoup benefits from improved access, they will use the DSM even though exporters of other countries can free ride on their efforts (Davis 2012). Thus we can expect that countries will refrain from using a DSM when damages from continued abrogation of a trade agreement do not outweigh the costs of arbitration, or when there appears to be a strong possibility of losing the arbitration process.

The way states factor the costs of litigation can be conceptualized in many ways, including legal experience, the availability of alternatives (i.e. forum shopping), industry characteristics, or the possibilities of political retaliation. Previous work has found that the probability of litigation within the WTO increases with legal experience, a result that is particularly strong for developing countries (Davis and Bermeo 2009). With previous experience, the costs of additional litigation are lower as states have the personnel and specialized knowledge. Studies have also found that behavior within the WTO litigation process may not be directly applicable to RTAs, or that there are potentially systematic differences in how states use the WTO dispute settlement system versus those in regional or bilateral agreements (Gomez-Mera and Molinari 2014, Hutnick 2014). This literature also found that the effects of previous experience vary: they are conditioned by a state's learning capacity and the amount of previous experience.

One reason there is observed behavioral difference between the WTO and RTAs is the concept of forum shopping, or the practice of choosing the most favorable jurisdiction or court in which a claim might be heard (Busch 2007, Davis 2012). Existing work on forum shopping finds a general bias towards using the WTO rather than RTAs (Froese 2014), as well as differences in regime type and forum choice (Busch 2007) the effects of political lobbying (Davis 2012), and legitimacy of the WTO over other forums (Davey 2005). Forum shopping also has implications for legal precedent: cases decided at a multilateral forum such as the WTO establish broad case law for international trade that is applicable to most countries. The risk of losing a case at the WTO increases the potential costs and benefits for countries in a way that that regional forums do not as the costs are potentially imposed by all major trading partners and not just the ones within a particular agreement. Following this logic, Busch (2007) has found that liberal countries tend to choose multilateral forums as they want to establish future case law. On the other hand, illiberal countries tend to choose regional forums as they can avoid being sued by other countries in the future using the precedent. The forum shopping concept has limited applicability when there is no overlap between institutional rules, which can be the case when RTAs offer considerably better terms of trade than the WTO (e.g. see Puig and Tat 2015).

The concept of herd behavior, or when a country files an identical or similar case against the same defendant country after a major country does the same, also possibly explains litigation decisions.[4] Iida points out that Japan's litigation behavior could be interpreted as a herd behavior (Iida 2006: 48). In other words, Japan uses the WTO DSM only if other affected countries are bringing up the same issue. In his article, of the 11 cases in which Japan was a complainant, ten of them could be considered herd behavior, and only one case could be considered "independent" behavior. This theory seems to be able to explain Japan's less use of RTA DSMs because most of Japan's RTAs are bilateral. Fear of crowds, on the other hand, is when a greater the number of third parties decreases the likelihood a country will use a DSM because negotiations become more complicated as more parties join (Johns and Pelc 2016). Japan has participated in disputes as a third party many times. Japan seems not to have this "fear of crowds" about joining a dispute, and if anything, herd behavior seems the more plausible explanation for Japan's litigation choices.

Industry-level effects also matter in a country's decision to litigate. Davis and Shirato (2007) found that differences in industry velocity affected Japan's initiation of the WTO DSM. High-velocity industries are those that face environments in which there is rapid and discontinuous change in demand, competitors, technology or regulation. They have many product lines and rapid product turnover, whereas a low-velocity business environment is the opposite. They found that high-velocity industries such as electronics were less likely to initiate a WTO DSM and low-velocity industries such as iron and steel industry were more likely to so. In addition to industry velocity, the degree of integration into global value chains may affect an industry's interest in pursuing litigation. Industries with more internationalized global value chains may be less likely to pursue active litigation in a DSM that favors 'silo-style' policies (Hoekman 2014). In particular, the role of the potential plaintiff in the industry's global value chain may make an industry leery of litigating. The political costs to alienating a partner country could be higher for industries that have more integrated or internationalized supply chains than for those that are simply exporting to a market. For example, if Japanese car manufacturers simply export to Indonesia their costs will be calculated differently than if they additionally

[4] Iida, K. (2006), supra note 48.

source components in Indonesia. Measuring the degree of supply chain integration on an individual firm level or industry level is challenging. We expect to find that the more an industry uses long global value chains, the less likely they would be to seek use of the DSM. These firms are more likely to internationalize behind tariff barriers and want to avoid any political costs or backlash.

WTO versus RTAs

The DSMs in the WTO are arguably used more than the RTAs because of its greater legitimacy. The WTO is rule-based rather than power-based, and panelists are (more) politically neutral. In one widely studied case, scholars found that NAFTA disputes were often brought to the WTO rather than the NAFTA DSM. In Japan's case, they lack some of the key institutional features of the WTO DSM that might enhance its legitimacy and effectiveness: time period of consultation, automatic operation, neutral experts and the rules for monitoring the implementation. Japan can improve these points regarding its RTA DSMs. There are some structural drawbacks in RTA DSMs in their implementation stages (Ahn 2013). In the case of retaliation by a complaining country, the party is allowed to raise RTA tariffs only up to the WTO Most Favored Nations Treatment (MFN) level. WTO member countries cannot raise their RTA tariff rates more than the WTO MFN level. This feature significantly reduces the utility of RTA DSMs and therefore the complaining country will prefer the WTO DSM.

Japanese Behavior in the WTO and its RTAs

RTAs incur political economy costs: Japan may opt not to formally participate in a DSM against a treaty partner because it would worsen relations with the country, and the RTA negotiation and completion process comes only with high effort and the expenditure of political capital with the inevitable losers from any trade agreement. Signing an RTA is also a symbol of diplomatic cooperation and closer political ties, as well as inviting closer economic cooperation. An RTA's core purpose is to strengthen an economic relationship with another country, and the dispute settlement mechanism is an institutional solution to make the agreements binding. However, we argue that the bilateral RTAs that Japan has signed do not defray the diplomatic costs to the same extent

that the multilateral WTO does. RTAs, in fact, can even depress DSM use because of fear of political backlash from a dispute. Japan has signed RTAs with many Southeast Asian countries where many Japanese companies trade and invest. Stable political relations among countries are desirable for business. We therefore hypothesize that, all else held equal, Japan will not use a DSM to countries when Japan has its RTAs with these countries.[5]

> *Hypothesis 1: The presence of an RTA will decrease the probability of using a dispute settlement mechanism.*

Another way to think about hypothesis 1 is that Japan's RTAs are symbols of deepening political cooperation as much as greater economic integration. Japan's RTAs are not independent of region: 8 of Japan's 14 RTAs are with Southeast Asian countries, and 12 of 14 are in the Asia-Pacific (the exceptions are India and Switzerland). Southeast Asia, in particular is growing in importance for Japan as an economic and political power. The first two of Japan's five principles of ASEAN diplomacy address political relations (promoting democratic values and supporting free and open seas and the United States rebalancing to the Asia-Pacific). The third principle is the promotion of trade and investment ties (Okano 2016).[6] Similarly, Japanese Minister of Foreign Affairs Kishida Fumio stressed the importance of political ties with ASEAN member states:

> ASEAN occupies a central role in peace and prosperity in the Asian region, as the core of political frameworks in East Asia, such as the East Asia Summit (EAS) and the ASEAN Regional Forum (ARF). It would not be difficult to imagine how vitally important and valuable it is for Japan to have such partnership with ASEAN… What I would like to state today is that Japan is an indispensable partner of ASEAN (Kishida 2016).

Southeast Asia is politically and economically important for Japan, particularly considering the emergence of China, and Japan may be hesitant to court conflict with Southeast Asian countries for this reason alone. We also hypothesize that, all else held equal, Japan is less likely to use or join a DSM with Southeast Asian countries in order to prevent the possibility of economic disputes disrupting their deepening diplomatic ties.

[5] Note: this result is in concurrence with Bown (2005: 108)..

[6] Principles four and five are protecting "Asia's diverse cultural heritages and traditions" and promoting youth exchanges.

We therefore predict that in order to maintain these strategic political ties, and to avoid the diplomatic costs of litigation, Japan will be unlikely to pursue use of a DSM with countries in Southeast Asia.

> *Hypothesis 2: In potential trade disputes with Southeast Asian countries, Japan will be less likely to use a dispute settlement mechanism.*

Studies such as Davis (2012, see Chapter 4) have controlled for country to capture individual state effects, but we argue there is a regional effecty.

It is important to note that this argument is not equivalent to one of "Asian culture", which argues for a normative inclination to pursue alternative forms of dispute resolution than litigation (see Kahler 2000 for a discussion), but rather political context and institutional design. While scholars have noted that Asian countries seem less likely to pursue litigation and choose instead to negotiate compromises (e.g. see Davey 2005), the empirical record shows an increasing shift towards using DSMs at the WTO (Moon 2013) and indeed incorporating increasingly legal language into trade agreements (Hoffman and Kim 2014). Allee and Elsig additionally cast doubt on assertion that "Asian culture" is not amenable to formal dispute settlement, arguing that Asian RTAs contain stronger dispute settlement rules, as do agreements in the Americas (Allee and Elsig 2014). Puig and Tat (2015) moreover demonstrate that much of what could be interpreted as cultural reluctance in Asian trade institutions are embedded in institutional design or can be explained by forum shopping.

With regard to Japan's political context, the Japanese legislature grants considerable autonomy to the bureaucracy for management of foreign trade policy (Davis 2012). As a result, there should be lower demand for adjudication and less politicization of case selection for WTO disputes, because of the relative absence of political pressure on foreign economic policy in Japan. When filing complaints, bureaucrats and industry take the lead with little interest from the legislature. Whereas U.S. officials, for example, face pressure to "get tough" with China, Japan has been able to pursue patient negotiations without the need to resort to adjudication to satisfy domestic demands. According to Davis, Japan follows a more selective adjudication strategy and initiates only a few cases for large industries with less obvious political influence on selection. Thus, both the domestic and foreign political and institutional contexts have been shown

to be more pivotal than cultural values, broadly defined; this paper contributes to that literature.

Methods and Data

To test our argument, we use a standard logit model to predict the probability that Japan will litigate in the event of a trade dispute. The outcome variable is a dispute settlement case, and thus the sample consists of litigated and non-litigated trade disputes between 1995 and 2015. Because Japan has never litigated a case within an RTA it presents problems for inference. We thus include all cases Japan has litigated or not litigated in all trade agreements (including the WTO court) to test economically and politically similar cases to Japan's bilateral RTAs.

Litigation cases include not only instances where Japan is the primary complainant (21 cases), but also ones where Japan has participated as a third party (157 cases). Japan's participation as a third party is high (88% of total cases), but it is not uncommon to see third parties in WTO cases. If a member country starts a dispute settlement procedure against other country, another member can join the dispute as a third party. Because of the most-favored nation rules of the WTO, third parties receive the benefits of the result of litigation. In the use of the WTO DSM, this type of free riding is not uncommon (Bown, 2005). Third-party participation is cheap, but valuable: it allows countries to guard their interests during negotiations and to voice their views during litigation, without paying the cost of initiating a DSM (Johns and Pelc 2016). States can extract private benefits from settlements and voice their interests by participating as a third party. That said, the greater the number of other third parties, the less likely a given country is to join because negotiations are more complicated as more parties join, which lowers the likelihood of early settlement (Johns and Pelc 2016).

The WTO documents all DSM cases, and counting is simple; a more difficult task is determining the instances where Japan decided not to litigate. To determine these cases, we follow the empirical strategy of Davis and Shirato (2007) to determine the disputes where Japan decided not to litigate. We code cases from two government reports on trade violations by Japan's partners: the Ministry of Economy, Trade, and Industry's (METI) annual *Report on Compliance by Major Trading Partners with Trade*

Agreements – WTO, FTA/EPA, BIT[7] and the Japan Machinery Center for Trade and Investment's (JMC) annual report *Issues and Requests for Improvements on Trade and Investments Barriers*. The purpose of the METI reports is to identify places where the policies of trading partners are inconsistent with international agreements. Davis and Shirato explain:

> The stated goal of the report is to examine the trade policies of major trade partners from the perspective of their consistency with international law, and to urge trade partners to change those policies if they conflict with international rules. METI officials compile a draft list of trade barriers primarily based on information from ministries and consultations with industry officials…According to a METI official, the report is specifically intended to provide a resource for identifying areas in which the Japanese government should initiate WTO complaints (2005: 288-9).

The JMC reports are produced by a private industrial organization, and include violations of trade agreements that do always overlap with the METI reports. The JMC reports are more effective for identifying industry's complaints that fall within the purview of Japan's RTAs, as the METI reports have a heavier focus on WTO violations. Using these reports, we identify 108 cases that are identified by the government of Japan or Japanese companies as violations of international trade agreements. These 108 cases are also not inclusive of all trade violations, which would likely number in the thousands, but rather those that either industry actors or METI identify as problematic trade violations that could possibly be worth the costs of litigation.

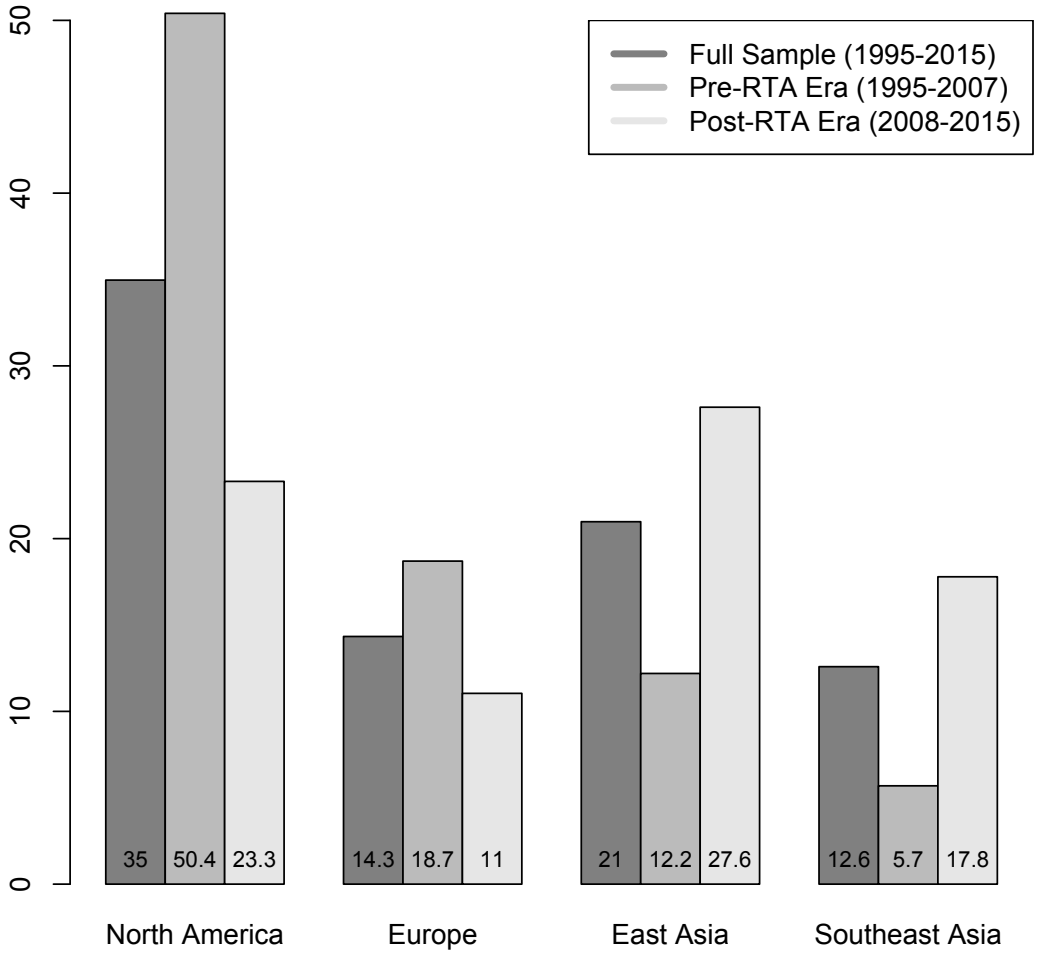
Explanatory Variables

Our key explanatory variables of interest are institutional and geographic: whether Japan has successfully negotiated an RTA with the country, and the disputing country's region. Japan has negotiated RTAs with countries that represent 14.3% of the cases, and the regional breakdown in the full sample of litigated and unlitigated cases is as follows: East Asia (21.0%), Southeast Asia (12.6%), South Asia (4.9%), North America (35.0%),

[7] This report was previously named *Report on the WTO Consistency of Trade Policies by Major Trade Partners*; it was renamed in 2007.

South America (4.5%), Europe (14.3%), Eurasia (3.5%), and Oceania (2.1%). Figure 1 shows the regional makeup of the full sample, as well as disputes from 1995-2007, when Japan had yet to sign any RTAs and from 2008-2016 after the RTAs began to take effect. While disputes with North American and European countries dominate the early sample, there is a marked shift to Asia after 2008 (other regions each constituted less than 5% of the subsets). East Asia constitutes a greater proportion than the United States, and Southeast Asia is almost at parity, demonstrating the increasing importance of regional trade for Japan, and the significance of the Chinese and ASEAN economies.

Figure 1: Disputes by Region and Time Period



Control Variables

We also include a panel of control variables as indicated by previous literature, including political economy costs, the expected benefits of formal participation, likelihood of success in a dispute, and sector-level effects.

Political economy costs include whether Japan was a respondent in past disputes of the WTO with the disputing trade partner, indicating retaliatory or "tit-for-tat" behavior (Iida 2004, Davis and Bermeo 2009).[8] We also control for past Japanese behavior with regard to a trading partner, including both whether Japan ever initiated a dispute or participated as a third party in a dispute against a country, in addition to the number of past disputes. We also include variables to control for the economic relationship with Japan, the level of development of the partner country, and the country's legal capacity (Kim 2008, Busch et al. 2009). Japan is less likely to use or join a DSM to a developed country because Japan may think the disputes would be solved by negotiation with developed country. Japanese may think developed countries are more likely to respect the result of negotiation although it is not legally binding. On the other hand, Japan may think developing countries are more likely to overturn the non-binding result of negotiation, or that it is not easy to negotiate with developing countries because of a weaker governance capacity. Developing countries also may not negotiate the issue sincerely without a formal compulsory dispute settlement process. For example, Venezuela tried to dismiss the award of the International Center for the Settlement of Investment Disputes (Business Wire 2015). If there is no legal binding dispute settlement system, countries like Venezuela may not negotiate to resolve disputes. Therefore Japan may think a legally binding DSM is preferable for resolving disputes with developing countries, whereas the country does not need to resort to a DSM to resolve disputes with developed countries.

We also control for the expected benefits of formal participation. We include Japan's exports sent to the disputing country as a share of Japan's total exports in t -1 as a measure of the importance of the disputing country as an export market. Japan's expected benefit from winning a dispute is higher than the cost of DSM when exports are high.

[8] One example of tit-for-tat behavior can be found in US-EU relations: the European Union's claim against the US over the foreign corporations is widely seen as retaliation for two past claims against EU from the US.

The GDP of a disputing country is a measurement of the size of economy of a disputing country. As Davis and Shirato mention, larger markets offer more economic opportunities for Japan's industry, although they also have more bargaining power. Japan may be more active or less active to participate in a dispute settlement process against a large economy considering both the size of the economy and the potential risks.

We additionally control for the likelihood of success in a dispute, which includes a measure of regime type, economic dependence of the partner country on Japan, and overseas development aid received from Japan. Following Zangl et el. (2008) and Davis (2012), we measure regime type (and by proxy the strength of domestic judicial institutions) with the polity IV index. Democratic governments incur higher noncompliance costs than their non-democratic states due to their exposure to domestic sources of noncompliance costs that non-democracies are not subject to (Fang 2010). Domestic interests groups and free media in a democracy play a significant role in publicizing a government's failure in working with international institutions.

Institutionalists argue that states comply with international legal norm because following the international rules keeps their good reputation as a law-abiding member of the international community. If this is true, Japan can use a DSM with expectation that a respondent country will follow the decision of a panel or arbitration. Third, liberalists think international law can be effective only among democratic states. Japan may think democratic countries will abide by international rules and decisions by a panel or arbitration and may prefer to use its DSMs to democratic countries because non-democratic countries may not follow the result of a panel or an arbitration. According to Davis, trade disputes may arise through either a failure of implementation in which exporters never gained the promised market access or through a new barrier that has been imposed in response to changed economic or political conditions. Low levels of liberalization would be less likely to lead to widespread cheating since compliance is easy, and as a result enforcement would rarely be a problem. On the other hand, deep liberalization commitments are more likely to give rise to incentives for cheating and encounter serious enforcement challenges.

Lastly, we control for sector effects. Following Davis and Shirato, we control for sector velocity. Their research shows how industry patterns affect the initiation of the

WTO DSM, using the Research and Development (R&D) ratio to total sale or production as a measure of velocity. Higher velocity industries such as electronics industries are less likely to use the DSM and lower velocity industries such as iron and steel industries are more likely to use the DSM. In order to examine the effects of sectoral difference in Japanese DSM initiation, we use R&D to total value added. This variable captures the stability of the business environment, degree of technological instability, and innovation. These data are from the OECD. In Davis and Shirato, total production is used but the OECD data do not show the total production of services. We use value added instead in order to include service industries in the analysis. In the data set, high velocity sectors include the chemical industry (34.1%), electric and electronic industry (23%), automobiles (17.8%), and manufacturing (11.5%).

Lastly, we control for the role of global supply chains for dispute initiation using the OECD's trade in value added (TiVA) measure by sector. When a sector has higher is highly integrated in TiVA, they may be more reluctant to engage in litigation as it can disrupt supply chains more broadly (Yildirim et al. 2008).

Results and Discussion

We estimate the probability of Japan litigating through a DSM as follows:

Pr (Japan Litigates) = RTA + TiVA + Velocity + Political Economy Controls + Regional, Sectoral, Trade Rule Controls

with the outcome variable measured as 0 (no litigation) or 1 (litigation).[9] The results are in Table 1.

Table 1: Regression Results

[9] We additionally use an ordered logit model where the outcome variable is 0 (no litigation), 1 (litigation as the primary disputant), or 2 (litigation as a third-party) with no substantive changes in results.

	Political Economy Model	Interaction Term	All Controls	Regional Controls	Sectoral Controls	Trade Violation Controls
RTA with Japan	-2.116***	-2.463	-5.239*	-2.006	-2.985***	-3.622**
	(0.586)	(4.543)	(2.380)	(8.476)	(0.766)	(1.195)
Sector Velocity	-5.991***	-5.996***	-3.298	-6.533***	-5.518	-9.457**
	(1.694)	(1.696)	(2.637)	(1.827)	(5.307)	(3.374)
Trade in Value Added	-0.449*	-0.452*	-5.002	-1.688	-0.557*	-0.442
	(0.198)	(0.203)	(5.142)	(2.273)	(0.219)	(0.284)
Japanese Exports	3.091	3.112	1.630	6.191	6.839	-7.264
	(3.950)	(3.961)	(1.478)	(7.205)	(4.843)	(6.318)
Japanese Imports	9.684*	9.567*	4.211	4.671***	0.668	1.117
	(4.208)	(4.470)	(3.292)	(1.371)	(5.133)	(7.605)
RTA*TiVA		0.0451				
		(0.587)				
Other Political Economy Controls	✔	✔	✔	✔	✔	✔
Sectoral Controls			✔		✔	
Regional Controls			✔	✔		
Trade Violation Controls			✔			✔
Intercept	- 22.982	-23.181	-1.347	4.292	0.576	-4.034
	(15.258)	(15.497)	(1.364)	(7.873)	(6.789)	(8.543)
N	310	310	310	310	310	310
AIC	315.02	317.02	183.07	298.75	276.57	182.37
Significance codes: 0 '***' 0.001 '**' 0.01 '*' 0.05 '.' 0.1 ' ' 1						

In all models but two, we find that controlling for all other variables, when Japan has an RTA with a country they are significantly less likely to decide to litigate. Figure 2 shows the likelihood of initiating a dispute as Japan's export dependence on a country increases from the full model (All Controls). When export dependence is low (less than 10%), Japan is four times more likely to initiate a dispute with a partner country with which they have no RTA. As export dependence increases, that gap narrows but does not entirely disappear. Note that the likelihood of litigating with an RTA is even lower than with a country in Southeast Asia, suggesting that there are institutional as well as regional issues preventing Japan from pursuing dispute resolution.

Figure 2: Export Dependence and DSM Use

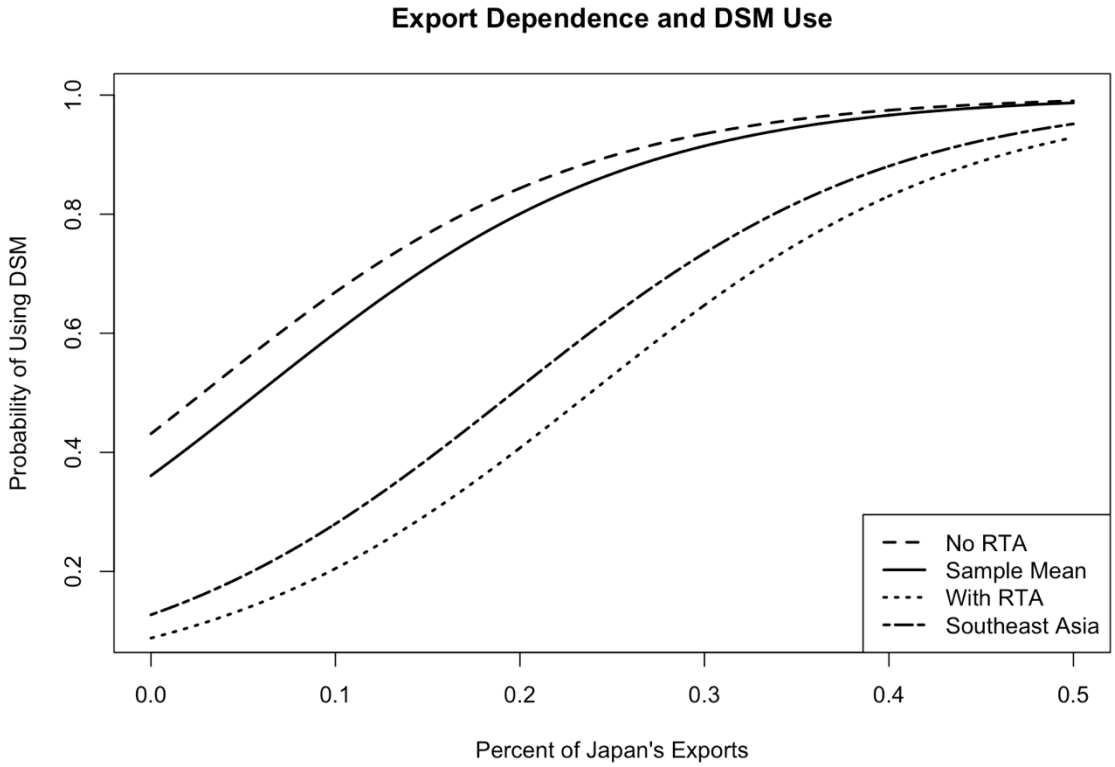
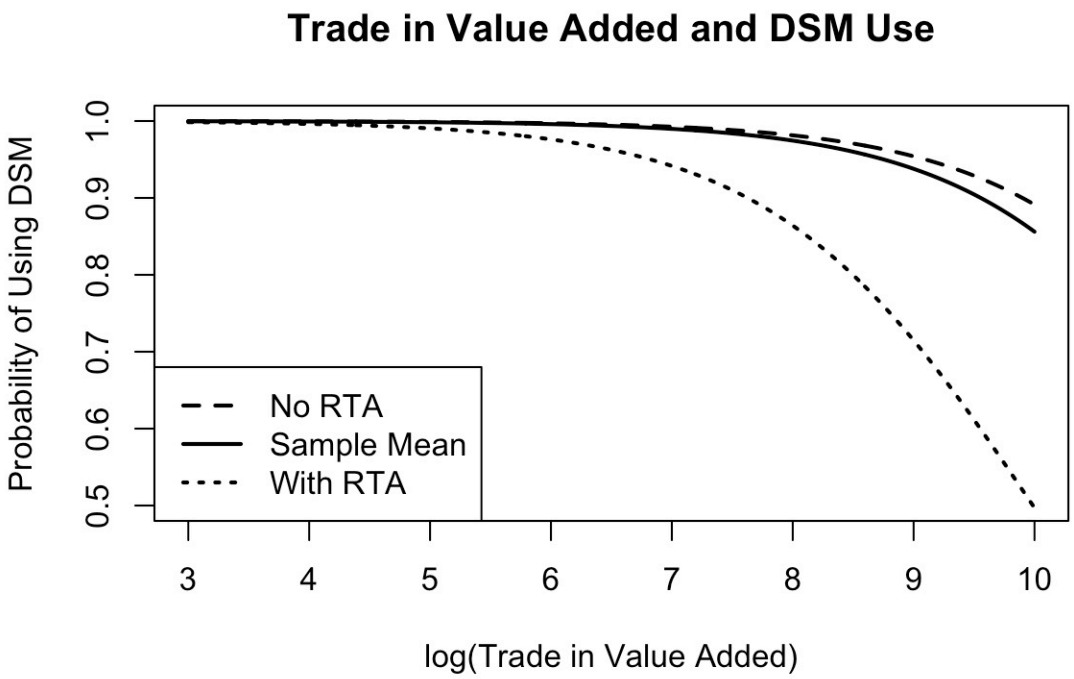


Figure 3 shows a similar result for trade in value added, although here the gap here grows larger as TiVA increases. When TiVA is low, the gap is near zero, but as it increases the probability of using an RTA DSM falls rapidly while countries without an RTA decline at a much slower rate. This result suggests that concerns about negative effects to supply chains are amplified in the context of important regional trading partners, particularly the very countries with which Japan has negotiated bilateral trade agreements.

Figure 3: Trade in Value Added and DSM Use



From our results, we can see that when controlling for the broader political economy, regime type, and economic logics behind the decision to pursue litigation, Japan is still less likely to use institutional solutions to problem solving with those countries with which it has successfully negotiated a RTA. The gap sometimes gets smaller – like when Japan has overall trade dependence with the country – but also gets larger when global supply chains are more likely to be affected.

In some models, particularly when we drop controls for all of the different types of disputes and sectors and control for region the RTA effect disappears and we find that when the likelihood of litigating falls when a dispute is with a Southeast Asian country. As we discuss in the conclusion, we believe these findings point to a sensitivity to the politicization of trade disputes and Japan's concern with positive diplomatic relations over economic gain.

Conclusions

When a country decides whether it should use a DSM, it considers the costs and benefits. Two sets of costs are particularly important: the direct costs of litigation such as

hiring lawyers and payment for arbitrators and the political economy/diplomatic costs. Benefits are related to the damage brought by a disputing country's measure violating the international trade rules. When costs of using the DSM are higher than the benefits, a country will not pursue litigation. The analysis in this paper shows that having a RTA and being a country in Southeast Asia depresses the likelihood of using or joining a DSM. These variables are related to political economic costs, Japan's concern for worsening relationship with disputing countries.

For example, in the dispute of "Indonesia, Export Restrictions on Mineral Resources and Local Content Issue", since the Indonesian Parliament passed the Mining Law in December 2008, the Japanese government has expressed its concerns to the Indonesian government at least 16 times. In this dispute, Japan has pursued negotiation to resolve the issue instead of using a DSM more almost a decade. As seen in this case, Japan has avoided using its newly available DSM.

Ideally using a DSM should not affect the relation of countries. In order to improve Japan's non participation in a DSM because of fearing worsening diplomatic relations, it is necessary to have a system which would ensure that DSM use would not worsen political relations. Otherwise, Japan will continue to pursue unofficial negotiations to resolve the dispute rather than joining an official dispute settlement process. This is similar to the idea of herd behavior. Of course, when other variables which positively affect Japan's decision of using or joining a DSM are very high, Japan joins a DSM. When export dependence is very high and sector velocity is low, for example, Japan does use the WTO DSM. However, that means Japan allows countries to violate trade agreements in some conditions. In order to ensure fair business environment, this situation should be avoided.

One possible solution is to pursue more multilateral DSMs that include powerful members such as the U.S. or EU so Japan would not have to bear the diplomatic costs of litigation alone. In the past, Japan was fearful of using a DSM with China and South Korea but Japan has started to use the WTO DSMs with both countries. The violation of rules of a disputing country is less likely to become bilateral problems in multilateral DSMs. However, most of Japan's RTAs which have come into effect are bilateral and Japan cannot collaborate with other countries to make a claim to a disputing country.

These disputes thus inevitably become bilateral issues between Japan and the disputing country. Within the institutional structure of Japan's current RTAs, political economic costs largely affect Japan's decision making.

These dynamics have the potential to change within the structure of the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), of which 4 of the 11 signatories are in Southeast Asia (Brunei, Malaysia, Singapore and Vietnam). Multilateral DSMs will dilute the tension between two countries brought by disputes in trade agreements, and Japan will be able to avoid bilateral disputes in multilateral trade agreements.Using a DSM can constitute a real diplomatic cost. Once formal litigation occurs between two countries, it becomes a diplomatic issue subject to domestic political pressures and media attention. However, it the disputes are not bilateral but multilateral, the situation will be different: the respondent country cannot effectively retaliate against many claimants and the dispute does not become bilateral diplomatic problems.

Increased institutionalization in Asia via multilateral and bilateral trade or investment agreements seems a symbol of the convergence of the region to institutional behaviors and norms seen in Europe or the Americas. However, this research demonstrates that institutionalization on paper is not equivalent to an active deepening of institutions. Increasing intra-regional economic integration is a well-acknowledged phenomena in East and Southeast Asia; it is not clear that the institutional framework will deepen in turn.

There could be issues of institutional design that could lessen Japan's reluctance to use litigation to resolve trade issues. Ahn points out some systematic institutional problems within Asian RTA DSMs (including Japan's), such as the lack of an appeal system or secretariat to support dispute settlement procedures. Japan's RTA DSMs lack an appeal system, a secretariat, and sometimes have a more limited scope than the WTO. For example, the Japan-Malaysia Economic Partnership Agreement's DSM does not apply to the Technical Barriers to Trade (TBT) or Sanitary and Phytosanitary Measures (SPS) (see Japan-Malaysia EPA, art. 67 and 72). Japan's RTA DSMs additionally do not

have a system for direct monetary compensation to settle disputes.[10] It is possible that these sorts of institutional changes could help, although they would not change the underlying political dynamics of the region.

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[10] Monetary payment for setting disputes is allowed in some RTAs such as the Korea-U.S. Free Trade Agreement, which is a recourse not available in the WTO DSM. In the KORUS, the complaining party may not suspend benefits if the responding party provides written notice to the complaining party that it will pay an annual monetary assessment (see KORUS, art. 22.13.5).

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