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Investor-State Dispute Settlement: An Anachronism Whose Time Has Gone

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Investor-State Dispute Settlement (ISDS) – a mechanism that allows foreign investors to bring claims against host governments to an international arbitral tribunal – is a postcolonial relic that should be abolished. Its alleged benefits have not materialized and its costs – monetary and other – can represent a formidable obstacle to good economic governance. We recommend policymakers to terminate ISDS provisions in existing agreements and eschew them in future trade and investment treaties.

Foreign direct investment (FDI) is widely viewed as an important pillar for a country's economic development. It is often also a key component of a broader sustainability agenda. UNCTAD (2014) calculates that global investment needs to reach the Sustainable Development Goals (SDGs) are in the order of USD 5-7 trillion per year. More than half of this amount is needed in developing countries, mainly for basic infrastructure (UNCTAD, 2014).

After a spectacular expansion starting in the 1980s and culminating in the late 1990s, global FDI flows have grown only sluggishly since the 2000s, displaying substantial volatility in comparison with e.g. global trade flows. Global FDI flows in 2017 amounted to USD 1.43 trillion, of which USD 671 billion flowed to developing countries, leaving a sizable gap with the amounts needed to advance a meaningful SDG agenda.

Attracting foreign capital has been a policy priority notably where capital is scarce. Policy makers around the world have been wooing investors with favorable investment policies for the past decades. Investor protection ranks prominently among those.

Investor protection is enshrined in more than 3000 International Investment Agreements (IIAs). Most of them are bilateral investment treaties. Some are part of other international agreements like the North American Free Trade Agreement (NAFTA), the Energy Charter Treaty and other upcoming agreements that are yet to enter into force like the Comprehensive and Progressive Trans-Pacific Partnership (CPTPP), the Regional Comprehensive Economic Partnership (RCEP) and the potential Transatlantic Trade and Investment Partnership (TTIP). All abovementioned trade agreements contain provisions for investor-state dispute settlement (ISDS), a mechanism which allows foreign investors to bypass domestic courts and bring claims against host governments to an international arbitral tribunal.[1]

Until July 2018, 855 known ISDS claims have been filed, of which 548 had been concluded. 200 of these claims have been decided in favour of the State, whereas 278 have been decided in favour of the investor or settled. The first ISDS case was filed only 30 years ago and fewer than 50 cases had been filed before the year 2000, making the increase in cases a recent phenomenon.[2]

The explosion of claims in the last two decades has been accompanied by mounting criticism of ISDS, which has led several countries to move away from including such provisions in their international treaties. A number of good reasons speak in favour of this development.

LACK OF ECONOMIC RATIONALE

Historically, IIAs have first been pushed by European investors as a response to legal uncertainty arising from the emergence of newly independent states in the wake of decolonization. As these newly independent states sought to wrest economic control from their former colonizers, the risk of nationalizations of foreign affiliates and their assets increased (UNCTAD, 2000, p. 5). While the initial IIAs did not include ISDS, today almost 95% of all BITs listed in UNCTAD's Investment Policy Hub contain such a clause.[3] The first bilateral investment treaty with ISDS is the 1968 treaty between the Netherlands and Indonesia, signed after several nationalizations of Dutch companies by Indonesia's first President Sukarno the year after his replacement.

In this context, political scientists have viewed ISDS as a means to reduce political risk associated with investments under uncertain political circumstances. In particular, "immobile investments" were seen to be at particular risk of potential post-investment state interference in foreign-owned property, as investors could not easily move their investments out of the country. However, looking at the structure of actual ISDS cases, there is no particular occurrence of claims related to immobile assets. In fact, roughly half of all known filings between 1990 and 2014 have been in sectors characterized by relatively mobile assets (Wellhausen, 2016).

ISDS has also been touted as 'depoliticizing' disputes, as it provides direct channels for investor claims, without resorting to diplomatic channels involving the home state (Rose-Ackerman and Tobin, 2005). In this logic, analysts credit ISDS with lowering "tensions that threaten the peace in the modern world" (Choi, 2007, p.736) and marking a significant shift away from "power politics and at times gunboat diplomacy" to solve disputes (Abbott et al., 2014, p. 5). It is not clear to what extent such kudos are still deserved. Since the signature of the first BITs with ISDS there have been important advances in the way

[1] The EU Canada Comprehensive Economic and Trade Agreement (CETA) swaps ISDS for an Investment Court System (ICS) that is permanent rather than ad hoc, has stricter rules on tribunal members and the scope of possible claims, establishes an appeals system and more transparency of proceedings. This policy brief focuses on ISDS as it is the most widespread form of investor protection and ICS is still in development. While ICS does offer improvements over ISDS, this policy brief focuses on issues that are relevant for both systems. All points of criticism of ISDS within this brief remain equally valid for ICS.

[2] http://investmentpolicyhub.unctad.org/ISDS?status=1000, consulted on August 25, 2018.

[3] Idem.

international economic disputes are handled. For example, the WTO Dispute Settlement Mechanism is widely credited as a crown jewel of international commercial relations. A purely state-to-state mechanism based on WTO rules, it may serve as a template for disputes related to investor protection as well.

More generally, realities appear not to correspond to the period of decolonization anymore, leaving analysts to wonder "what the problem is that is being addressed" (Lester, 2015, p. 213). Countries around the world are wooing foreign investors through favorable policies, as FDI is widely seen as something positive and worth attracting. This phenomenon is so marked that some observers even worry that the quest to attract foreign investors has led to a "race to the bottom", as countries compete for investors in terms of tax competition or labor standards (see e.g. Davies and Krishna, 2013). Residual political risks are inherent to any business decision. Just as any investor, a foreign investor will need to account for different degrees of risk according to which country she invests in. Introducing tools such as ISDS to mitigate political risks for foreign investors and not for domestic ones stands on shaky economic grounds – in particular also in view of the availability of political risk insurance.

UNCLEAR EFFECTS OF ISDS ON FDI

The objective of signing on to ISDS provisions is to increase FDI flows that would ultimately translate into economic benefits. Preambles of IIAs are rife with such stated objectives. However, even the basic premise linking the adoption of IIAs – let alone ISDS – with increased FDI flows is not supported by either empirical facts or qualitative evidence. The absence of an investment treaty between China and the US does not preclude substantial bilateral investments between the two countries and despite not having signed on to a single investment treaty with ISDS provisions Brazil currently ranks as the fourth largest FDI recipient worldwide (WIR 2018). South Africa, Indonesia and India have all seen their FDI inflows unchanged – or even improved – in the wake of substantial steps undertaken away from traditional ISDS (Johnson et al., 2018). While all these countries wield considerable economic power and are inherently interesting options to foreign investors, the non-existence of strong links between IIAs and FDI go beyond these cases. Recent comprehensive reviews looking at dozens of studies such as Bellak (2015) and Bonnitcha et al. (2017), which investigate correlations between the existence of IIAs and FDI flows across a number of countries and controlling for various factors including economic power, do not find consistent evidence of any effect. This ambiguity suggests that IIAs and ISDS in particular play at best minor roles in investment decisions, which are rather determined by other factors. Interestingly, some evidence even finds that once an ISDS claim is filed countries observe reductions in FDI inflows, regardless of whether the case is lost or won (Allee and Peinhardt (2011) and Aisbett et al. (2018)).

NOT ALL FDI IS EQUALLY BENEFICIAL

The link between FDI and economic activity is relatively well documented (see e.g. Alfaro (2017) for a recent review). Evidence shows that FDI inflows can have a variety of effects in host economies, both positive and negative. The specific impact of any single one flow depends on several factors related to the host economy and the nature and purpose of the transaction (Pohl, 2018). Sought-after effects like knowledge spillovers, backward and forward linkages with local firms, technology transfer, improved managerial skills, employee training, as well as access to international production networks and markets are all rarely the automatic result of mere investment flows. For example, investment in mining often results in enclave development where goods and services are imported, employees are foreign, extracted material is sold unprocessed and there is little resulting benefit to the host economy beyond taxes and royalties (Cosbey and Ramdoo, 2018). In order to achieve pressing public goals, smart policy needs to identify welfare enhancing FDI flows that benefit the host economy in terms of economic, social and environmental outcomes (Johnson, 2017). ISDS is an ill-suited instrument to target this objective, as it is a blanket measure that treats all FDI alike.

ISDS STYMIES GOOD GOVERNANCE

Originally conceived of as strengthening the rule of law in states with underdeveloped domestic legal systems, there is mounting suspicion that ISDS is counterproductive to targeting this objective. By resorting to international arbitration, ISDS substitutes for the use of domestic legal institutions and can thereby entrench their weaknesses. The availability of ISDS on the international level relieves states from external pressure to improve domestic government mechanisms and practices (Sattorova, 2014). Since domestic firms do not have access to ISDS procedures, they lose a natural ally in pushing for improved governance at home, leaving them competing in a very different context than rival foreign competitors in the same country.

The difference in law for foreign and domestic enterprises that the availability of ISDS entails is not only procedural, but also substantive. As domestic courts are largely bypassed, arbitration tribunals have key powers to interpret and apply issues of domestic law from a commercial rather than public policy perspective, often times resulting in a balance tipped in favor of private rather than public interests (Johnson and Volkov, 2013). This tendency has led to a shifting of bearing the risk of regulatory change from the investor to the government to an extent that goes beyond what domestic legal frameworks would allow (Johnson et al., 2018). Consequently, the inadequate pricing of the risk associated with foreign investments can lead to moral hazard problems, in which investors might undertake projects that do not properly take account of the externalities they generate, as ISDS acts as an insurance policy against future government action to redress these (Bonnitcha, 2011). An investment in a coal plant is likelier to go ahead, for example, if the investor expects ISDS to constrain the government in taking future climate action.

The obstacles for governments to enact regulations and policies that may provide for crucial social or environmental benefits for fear of ISDS litigation are also referred to as "regulatory chill" (e.g. Tienhaara, 2018). Even though an IIA does not in itself and directly limit the legislative or regulatory powers of states it may lead governments to thread more cautiously – and hence potentially insufficiently from a public-interest perspective – when planning and designing regulation (Pohl 2018). As United States Trade Representative Robert Lighthizer recently noted: "We've had situations where real regulation which should be in place which is bipartisan, in everybody's interest, has not been put in place because of fears of ISDS." In the context of ISDS claims against tobacco-control measures implemented in Uruguay and Australia, several other countries that had planned similar policies are reported to have delayed the passing of the contentious policy to await the tribunals' decisions in these cases (Pohl 2018). Empirical studies suggest that foreign firms use ISDS strategically, publicly and repeatedly filing cases to coerce governments to agree on favorable terms for their investments, rather than turning to ISDS as a measure of last resort (Hafner-Burton et al., 2016). In view of the potential liabilities such regulatory chill comes as no surprise. In cases decided in favor of the investor, the average amount claimed as of the end of 2016 was $1.4 billion, the average amount awarded was $545 million, plus interest (UNCTAD, 2017a).

END IT, DON'T TRY TO MEND IT

While current reform efforts seek to address some of the legal and institutional flaws of the system, the bigger picture suggests that ISDS is ineffective in attracting FDI and may significantly hamper good governance. Reforms will fall short in addressing this. In fact, as argued in a recent rebuke of ISDS, "the main efforts at reform are directed not to questions of substance, but to the creation of institutions […] that […] can be expected to build upon and institutionalize the serious flaws in the existing system" (Kahale III, 2018).

As noted by UNCTAD (2017b), over 1000 bilateral investment treaties have now reached a stage where they could be unilaterally terminated immediately by one contracting party. Many more will become available for such termination over the next few years. Policymakers thus face a historic window of opportunity to reconfigure the landscape of international investment agreements. Abolishing ISDS provisions in existing treaties should be on top of their priority list; eschewing them in future trade and investment agreements also.

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