



# Free Trade Bulletin

No. 57 • March 4, 2014

## A Compromise to Advance the Trade Agenda: Purge Negotiations of Investor-State Dispute Settlement

by Daniel Ikenson

### Introduction

President Obama's major trade initiatives, the Trans-Pacific Partnership, the Transatlantic Trade and Investment Partnership, and obtaining fast-track trade negotiating authority from Congress, have run into a buzz saw of opposition, which has derailed prospects for U.S. trade liberalization for the time being.

What began as the usual objections from the usual suspects—labor unions blaming trade for manufacturing decline and job loss; environmental groups blaming trade for climate change; anti-globalization activists sparing the developing world from development—has grown into a populist backlash against the TPP, which is portrayed as a secretive, corporatist plot to circumvent democratic processes and usurp national sovereignty. The nascent TTIP negotiations have been smeared with a similar taint.

Characterizations of the TPP as a scheme to boost the fortunes of tobacco, oil and gas, banking, and pharmaceutical companies at the expense of worker protections, the environment, public health, and food and product safety have gone viral. And without so much as a single public repudiation of these claims by the president those perceptions are sticking.

As is true of most populist causes, buried beneath the enabling mythology and hyperbole are some kernels of truth. One such truth, which this paper seeks to distill from the vacuous, anti-capitalist hyperventilation surrounding the trade agenda, is that the so-called Investor-State Dispute Settlement (ISDS) mechanism, which enables foreign investors to sue host governments in third-party arbitration tribunals for treatment that allegedly fails to meet certain standards and that results in a loss of asset values, is an unnecessary, unreasonable, and unwise provision to include in trade agreements. Although detractors may not know

it by name, ISDS is a significant reason why trade agreements engender so much antipathy. Yet, ISDS is not even essential to the task of freeing trade. So why burden the effort by carrying needless baggage?

Purging both the TPP and the TTIP of ISDS makes sense economically and politically, would assuage legitimate concerns about those negotiations, splinter the opposition to liberalization, and pave the way for freer trade.

### What's Troubling the Trade Agenda?

President Obama has failed to make an affirmative case for his trade agenda, and his disinterest in rebutting the flood of damaging portrayals of the TPP has permitted germinating dissent to metastasize into a problem much worse. Meanwhile, the nature of trade, the nature of protectionism, and the substance of trade agreements have changed with the proliferation of cross-border investment and transnational supply chains. As companies establish operations in foreign markets, where they are engaged in direct and more intense competition with incumbent firms, concerns about protectionism are no longer confined to the border.

Protectionism manifests in more subtle ways today. Accordingly, ensuring nondiscrimination against imports, foreign investment, and the operations of foreign companies requires rules that sometimes burrow into areas that were once the exclusive purview of domestic legislatures and regulators. Agreements nowadays include provisions affecting domestic intellectual property laws, environmental and labor standards, data flow and storage requirements, banking regulations, and food and product safety requirements, to name some.

The interplay of domestic governance and trade agreement obligations has raised questions about jurisdiction, sovereignty, and the separation of powers. That some perceive the TPP as secretive has heightened sensitivity about its objectives and implications. So, instead of seeing negotiations on "regulatory coherence" as a commonsense way for businesses to reduce the costs of compliance with-

---

*Daniel Ikenson is director of the Herbert A. Stiefel Center for Trade Policy Studies at the Cato Institute.*

out compromising public health or safety objectives, some suspect it is a path to gutting compliance obligations altogether. Others see regulatory harmonization as another step toward global governance. Efforts to include provisions extending protection of patents, copyrights, and other forms of intellectual property are perceived by some as attempts to impose through treaty what was unachievable through domestic processes. Negotiations of rules that would help ensure that financial-sector regulations are promulgated in manners that are nondiscriminatory are painted as attempts to weaken domestic safeguards against recurrence of a financial meltdown.

The hallmarks of tighter global economic integration—cross-border investment, transnational supply chains, and intensifying competition—have created tension between the imperative of domestic sovereignty and the growing demand for rules to guard against protectionism and discrimination. One area where this debate has gotten especially heated is tobacco regulation.

Anti-tobacco advocates have been demanding a “carve out” provision, which would excuse lawmakers and domestic agencies from their obligations to craft and enforce tobacco regulations in manners that do not discriminate against imports. The rationale for the safe-harbor provision is that tobacco poses special known risks to public health and human safety and that trade obligations should not interfere with the capacity to regulate such a dangerous product. Recently, 42 of the 50 U.S. state attorneys general signed a letter insisting that such a safe-harbor provision is essential to protecting public health.<sup>1</sup>

But as trade experts have explained, there is nothing about the TPP or any other trade agreement that impedes a government’s capacity to protect human life or health. Trade agreements do not prohibit regulating. They merely require that such measures be based on sound science and that discrimination against similar products on the basis of national origin be avoided. The states can ban cigarettes, for example, but not cigarettes “from Indonesia.” As Cato trade policy analyst Simon Lester puts it: “Although there may be valid concerns about some of the more recent additions to trade and investment agreements ... the core of these rules constrains domestic regulation only to the extent that such regulation discriminates against imports and does not preclude legitimate domestic policymaking.”<sup>2</sup>

But if one listens closely to the arguments of anti-tobacco advocates (or reads the letter from the 42 attorneys general), what most oppose is the possibility of tobacco companies suing the U.S. government in third-party tribunals. Creating a tobacco carve out would reiterate a right that governments already possess and would do nothing to safeguard against suits by tobacco companies—or any other companies.

The real ire of anti-tobacco advocates is the Investor-State Dispute Settlement mechanism.

### **What is Investor-State Dispute Settlement?**

The ostensible purpose of ISDS is to ensure that foreign investors—usually multinational corporations (MNCs)—are protected against host government actions or policies that fail to meet certain standards of treatment and that cause

the investor economic harm. The ISDS confers special legal privileges on foreign-invested companies, including the right to sue host governments in third-party arbitration tribunals for failing to meet those standards.

Investor-State Dispute Settlement dates back to the era following World War II, when previous European colonies were achieving independence and seeking to attract Western investment. It was borne as an expedient to overcome concerns about expropriation by new governments lacking experience with property rights and the rule of law.<sup>3</sup> But ISDS procedures were rarely used. In fact, from the inception of ISDS in 1959 through 2002, the number of known ISDS claims worldwide stood at fewer than 100.<sup>4</sup> However, during the 10 years between 2003 and 2012, the cumulative total increased to 514 cases.<sup>5</sup> In 2012, claimants initiated 58 ISDS cases worldwide, which was the greatest number of initiations in any year, surpassing the previous record set in 2011.<sup>6</sup>

Provisions for ISDS are included in the 41 U.S. bilateral investment treaties in effect, as well as most of the U.S. bilateral trade agreements.<sup>7</sup> American TPP and TTIP negotiators are seeking ISDS rules in those agreements. Proponents argue that ISDS provides assurances against unfair treatment from host governments, strengthens the rule of law, and helps bring otherwise reluctant investors to capital-hungry jurisdictions. But looking more closely, ISDS arguably weakens the rule of law, forces the public to subsidize the risk of MNC investment abroad, and effectively encourages outsourcing.

### **Eight Good Reasons to Drop ISDS from TPP and TTIP**

There are practical, economic, legal, and political reasons to expunge ISDS from current trade negotiations.

First, *ISDS is overkill*. Governments are competing to attract productive investment to keep their citizens employed and their economies growing. Accordingly, it is imperative to maintain smart, transparent, predictable policies that are administered fairly and nondiscriminatorily. Asset expropriation or other forms of shabby treatment of foreign companies is not likely to be rewarded by new investment.

Of course, that doesn’t guarantee that policies will never go astray. Sometimes they will. But investment is a risky proposition. Foreign investment is usually more risky. But that doesn’t necessitate the creation of institutions to protect MNCs from the consequences of their business decisions. Multinational companies are among the most successful and sophisticated companies in the world. They are quite capable of evaluating risk and determining whether the expected returns cover that risk. Although MNCs may want assurances, they don’t need them.

Multinational companies can mitigate their own risk by purchasing private insurance policies. Alternatively, they can condition investment on the host government’s agreeing to other protections, contractually. Whether the host agrees would be influenced by the supply of potential investors and the strings they would attach.

Second, *ISDS socializes the risk of foreign direct investment*. When other governments oppose, but ultimately

concede to, U.S. demands for ISDS provisions, they may be less willing to agree to other reforms, such as greater market access, that would benefit other U.S. interests. That is an externality or a cost borne by those who don't benefit from that cost being incurred. In this regard, ISDS is a subsidy for MNCs and a tax on everyone else. Taking the argument one step further, ISDS not only subsidizes MNCs, but particular kinds of MNCs. What may be too risky an investment proposition without ISDS for Company A is not necessarily too risky for Company B. By reducing the risk of investing abroad, then, ISDS is a subsidy for more risk-averse companies. It is a subsidy for Company A and a tax on Company B.

Third, *ISDS encourages "discretionary" outsourcing*. In the global competition to attract investment from the world's best companies, the United States has some enormous advantages. For many decades, the United States has been the world's premier destination for foreign direct investment. But in recent years, the United States has been slipping in a number of important investment-location decision criteria and, accordingly, its share of global foreign direct investment has declined from 39 percent in 1999 to 17 percent in 2011.<sup>8</sup>

While ISDS may benefit U.S. companies looking to invest abroad, it neutralizes what was once a big U.S. advantage in the competition to attract investment. Respect for property rights and the rule of law have been relative U.S. strengths, but ISDS mitigates those U.S. advantages. Access to ISDS could be the decisive factor in a company's decision to invest in a research center in Brazil, instead of the United States. Why should U.S. policy reflect greater concern for the operations of U.S. companies abroad than for the operations of U.S. and foreign companies in the United States? Why should ISDS effectively subsidize outsourcing, and not insourcing?

To be sure, success abroad and success at home are closely correlated. Companies must be able to invest abroad to compete there, and the success of those foreign affiliates tends to be reflected in the performance of the parent companies at home.<sup>9</sup> But there is a crucial distinction between "discretionary" and "nondiscretionary" outsourcing.

"Discretionary" outsourcing is investment that goes abroad, but doesn't really have to. It is investment in activities that could be performed competitively in the United States, but is chased away by policies that make U.S. investment relatively more expensive. "Nondiscretionary" outsourcing is investment in activities that requires a foreign presence.

While we should not denigrate, punish, or tax foreign outsourcing, neither should we subsidize it, and ISDS subsidizes discretionary outsourcing.

Fourth, *ISDS exceeds "national treatment" obligations*, extending special privileges to foreign corporations. An important pillar of trade agreements is the concept of "national treatment," which says that imports and foreign companies will be afforded treatment no different from that afforded domestic products and companies. The principle is a commitment to nondiscrimination. But ISDS turns national treatment on its head, giving privileges to foreign

companies that are not available to domestic companies. If a U.S. natural gas company believes that the value of its assets has suffered on account of a new subsidy for solar panel producers, judicial recourse is available in the U.S. court system only. But for foreign companies, ISDS provides an additional adjudicatory option.

This inequality of treatment seems to run afoul of the investment provisions in the Baucus-Hatch-Camp legislation (to extend fast-track trade promotion authority to the president), which state that the principal U.S. negotiating objectives regarding foreign investment are to: "[R]educe or eliminate artificial or trade distorting barriers to foreign investment, while ensuring that foreign investors in the United States are not accorded greater substantive rights with respect to investment protections than United States investors in the United States..."<sup>10</sup>

Foreign investors having recourse to the U.S. legal system and then, if that produces unsatisfactory results, to third-party ISDS procedures arguably constitutes greater substantive rights for them than for domestic investors, whose options are confined to the U.S. legal system.

Fifth, *U.S. laws and regulations will be exposed to ISDS challenges* with increasing frequency. The number of cases is on the rise. Most claims have been brought against developing countries—with Argentina, Venezuela, and Ecuador leading the pack—but the United States is the eighth-largest target, having been the subject of 15 claims over the years.<sup>11</sup>

As the percentage of global Fortune 500 companies domiciled outside the United States continues to increase, U.S. laws and regulations are likely to come under greater scrutiny. The specter of foreign companies prevailing in challenges of U.S. laws outside the U.S. legal system would frustrate further the task of selling trade to a skeptical public and would reward trade critics who have been warning of just such an outcome for many years.

Investor-State Dispute Settlement raises concerns about domestic sovereignty. Among recent cases highlighting these tensions is a suit brought by Philip Morris, Inc. against the Australian government for a law requiring that cigarettes be sold in plain packaging. Philip Morris claims that the requirement deprives it of its property (trademarks, logos, and labels), which is important for brand recognition and without which its revenues will decrease. Philip Morris may have a legitimate claim, but the optics will not be favorable for trade agreements if the company prevails.

Meanwhile, growing concerns in Europe about the vulnerabilities of environmental and public-safety laws to challenges by foreign corporations—sparked, in part, by a case brought by a Swedish energy company against Germany for its decision to abandon nuclear power—have led the EU to suspend ISDS negotiations in the TTIP for a period of three months, as it collects and evaluates public comments and reconsiders its position. Realistically, it is difficult to conceive of any benefits to including ISDS provisions in the TTIP, given the advanced legal systems in the United States and Europe, unless the wave of the economic future is expected to arrive in a tsunami of international litigation.

Sixth, *ISDS is ripe for exploitation by creative lawyers*. There is a lot of latitude for interpretation of what constitutes “fair and equitable” treatment of foreign investment, given the vagueness of the terms and the uneven jurisprudence. Thus, ISDS lends itself to the creativity of lawyers willing to forage for evidence of discrimination in the arcana of the world’s laws and regulations. Among the complaints worldwide in 2012 were challenges related to “revocations of licenses, breaches of investment contracts, irregularities in public tenders, changes to domestic regulatory frameworks, withdrawals of previously granted subsidies, direct expropriations of investments, tax measures and others.”<sup>12</sup>

Meanwhile, some agreements are attempting to expand the definition of a breach of the obligation of host governments to provide fair and equitable treatment to include: “targeted discrimination on manifestly wrongful grounds, such as gender, race or religious belief.” This attempt to broaden the scope for complaints—included in the EU-Canada trade agreement—should be a cause for concern.<sup>13</sup>

Seventh, *ISDS reinforces the myth that trade primarily benefits large corporations*. A persistent myth that has proven hard to dispel permanently is that trade benefits primarily large corporations at the expense of small businesses, workers, taxpayers, public health, and the environment. The fact is that trade is the ultimate trustbuster, ensuring greater competition that prevents companies from taking advantage of consumers. Lower-income Americans stand to benefit the most from trade liberalization, as the preponderance of U.S. protectionism affects products and services to which lower-income Americans devote higher proportions of their budgets.

But by granting special legal privileges to multinational corporations, ISDS reinforces that myth and is a lightning rod for opposition to trade liberalization. It is effectively a subsidy that mitigates risk for U.S. multinational corporations and enables foreign MNCs to circumvent U.S. courts when lodging complaints about U.S. policies. Ultimately, ISDS is unimportant to the task of trade liberalization and its inclusion in trade agreements only strengthens trade’s opposition.

Eighth, *dropping ISDS would improve U.S. trade negotiating objectives, as well as prospects for attaining them*. Recently, a group of business associations joined in a statement of opposition to the requests for a tobacco carve-out provision, arguing that it would be superfluous and set a dangerous precedent that would undermine the settled view that governments are already entitled to regulate in the interest of protecting human life or health.<sup>14</sup> Given their concern for the rule of law and the traditions of the trading system, the statement’s signatory organizations should be amenable to a compromise that would include purging ISDS from the TPP and the TTIP in exchange for a denial of the carve-out language.

Such a deal would assuage thoughtful critics of the trade agenda, who do not oppose trade, but who believe trade agreements should be more modest and balanced. Meanwhile, what now appears to be an angry mob protesting trade generally will be thinned out, exposing the unsubstantiated arguments of the professional protectionists who benefit by impeding Americans’ freedom to trade.

## Conclusion

For practical, economic, legal, and political reasons, ISDS subverts prospects for U.S. trade liberalization. Yet it is tangential, at best, to the task of freeing trade. Any benefits to availing MNCs to third-party adjudication are all but totally overwhelmed by the additional costs. In the proverbial airplane that is down one engine and losing altitude, throwing ISDS out of the cargo hold to reduce unnecessary weight is the best solution.

At this point, it remains unclear whether the president is genuinely committed to doing what it will take to advance his trade agenda. But should he convince himself of the efficacy and righteousness of freeing trade and become interested in putting the necessary pieces together to bridge political divides, jettisoning ISDS and explaining how doing so liberates us from legitimate concern that corporations will run roughshod over domestic laws could go a long way toward selling these agreements to the public.

## Notes

1. Inside U.S. Trade’s World Trade Online, “Attorneys General From 42 States Call For Tobacco Carveout In Trade Deals,” February 6, 2014, [www.insidetrade.com](http://www.insidetrade.com).
2. Simon Lester, “Free Trade and Tobacco: Thank You for Not Smoking (Foreign) Cigarettes,” *Cato Free Trade Bulletin* no. 49, August 15, 2012.
3. For a good history of ISDS, see Simon Lester, “Liberalization or Litigation? Time to Rethink the International Investment Regime,” *Cato Policy Analysis* no. 730, July 8, 2013.
4. United Nations Conference on Trade and Development (UNCTAD), “Recent Developments in Investor-State Dispute Settlement (ISDS),” *IIA Issue Notes* No. 1, May 2013.
5. *Ibid.*
6. *Ibid.*
7. Shayerah Ilias Akhtar and Martin A. Weiss, “U.S. International Investment Agreements: Issues for Congress,” *Congressional Research Service*, April 29, 2013.
8. Daniel Ikenson, “Reversing Worrisome Trends: How to Attract and Retain Investment in a Competitive Global Economy,” *Cato Policy Analysis* no. 735, August 22, 2013.
9. *Ibid.*, Figures 4, 5, 6, 7, 8, and 9; Matthew J. Slaughter, “American Companies and Global Supply Networks: Driving U.S. Economic Growth and Jobs by Connecting with the World,” *Business Roundtable*, the United States Council for International Business and the United States Council Foundation, January 2013.
10. United States Senate, *Bipartisan Congressional Trade Priorities Act of 2014*.
11. United Nations Conference on Trade and Development. To date, investors have not prevailed in any of their complaints against the United States.
12. United Nations Conference on Trade and Development.
13. Simon Lester, “An Equal Protection Clause for Investment,” *International Economic Law and Policy Blog*, February 6, 2014.
14. U.S. Chamber of Commerce, et al., “Joint Statement on Proposal to Modify Longstanding “General Exception” Provision and Dispute-Settlement Provision in the Trans-Pacific Partnership (TPP) Negotiations,” February 2014, [http://www.amcham.com.au/Downloads/99a9e9a3-1e17-4180-a6a6-72dd380a65ca/Joint\\_Statement.pdf](http://www.amcham.com.au/Downloads/99a9e9a3-1e17-4180-a6a6-72dd380a65ca/Joint_Statement.pdf).