NATIONAL REVIEW

An Unfortunate Casualty of the 'New NAFTA'

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Investor–state dispute settlement is in America's interests and should be maintained.

Congressional ratification of the new U.S.–Mexico–Canada Agreement (USMCA) is essential to avert massive disruption of the North American economy. Otherwise Trump may prove good to his word and terminate the original NAFTA, thereby resurrecting tariffs and other barriers to continental commerce — a fine recipe for recession in 2020.

But USMCA is not an agreement made in heaven, and one defect is its severe limitations on investor–state dispute settlement (ISDS). Robust ISDS was a triumph of the original NAFTA, and the NAFTA model was rightly championed by successive presidents until Trump reached the White House.

The rules of ISDS protect firms that invest abroad against unfair treatment by foreign governments in three major ways. First, they restrict direct and indirect expropriation. Direct expropriation means outright seizure of foreign firms' property without compensation; indirect expropriation refers to opaque taxes and regulations. Second, ISDS ensures that foreign firms enjoy the same rights as domestic firms (national treatment) and third-country firms (most-favored-nation treatment). Last, ISDS requires governments to provide "fair and equitable treatment" to foreign firms. ISDS rules are enforced by international arbitration, which enables foreign firms to challenge unfair treatment by local governments and win money awards.

While ISDS is designed to protect investors, it also serves as a seal of "good housekeeping" for developing countries that wish to attract foreign firms. ISDS provisions are so popular that they have been written into some 2,200 bilateral investment treaties and free-trade agreements. To date, around 565 arbitrations have been conducted under the auspices of the International Center for the Settlement of Investment Disputes (ICSID), a body housed within the World Bank. Foreign firms have filed just 16 cases against the U.S. government and have never won an award.

Under the USMCA, ISDS between Canada and the United States will no longer be available for new investments. Existing investments will be covered for three years after NAFTA is terminated — an event that will follow ratification of USMCA. At that point, investment disputes can be resolved only in Canadian or U.S. courts, or through state-to-state diplomatic proceedings. These alternatives are neither fast nor impartial.

The United States and Mexico agreed to keep ISDS provisions, but with a much narrower scope. Investment disputes against Mexico can be brought only in "covered sectors," namely sectors where U.S. investors have entered into contracts with the Mexican government involving energy, power generation, telecommunications, transportation, and infrastructure projects. Those making

claims against the United States and claims in other sectors against Mexico can seek compensation for breach of national treatment, breach of most-favored-nation treatment, or expropriation, but not for the breach of "fair and equitable" treatment. Moreover, indirect expropriation no longer covers government actions that diminish the economic value of an investment or interfere with investment-backed expectations, in the absence of a binding written assurance from the host government. These provisions are legally symmetrical with respect to Mexican investments in the United States, but since the U.S. government has limited presence in the covered sectors, symmetry has little practical effect.

Left-wing ISDS opponents including Senator Elizabeth Warren rely on three misleading charges to demonize the system. First, they argue that arbitrators serve corporate clients one day and decide ISDS cases the next. This criticism overlooks the fact that arbitrators are selected from a large panel of qualified attorneys and that each side has several opportunities to remove candidates with potential bias. Moreover, arbitrators take an oath of impartiality: They commit to decide cases based strictly on the law and the facts. Both Mexico and the U.S. embraced the existing selection procedure for arbitrators.

Second, left-wing opponents of ISDS argue that national courts should decide disputes. This criticism overlooks the specialized legal nature of international investment disputes and the fact that national courts are often clogged. Moreover, many developing countries, exemplified by Mexico, want ISDS provisions to make themselves attractive to multinational corporations — and they want the attractions to survive a change in government.

Third, these critics argue that ISDS decisions threaten to overturn local laws protecting labor, heath, and the environment. No factual basis exists for this overwrought complaint. The U.S. and Mexico explicitly state that nondiscriminatory regulations applied to protect legitimate public-welfare objectives such as health, safety, and environment do not constitute indirect expropriation.

Right-wing opponents of ISDS, concentrated at the Cato Institute, argue that the U.S. should not be improving the investment climate abroad. In their view, ISDS only deflects investment from the United States to foreign shores. Key officials in the Trump administration, notably Ambassador Robert Lighthizer, evidently sympathize with this argument. But the criticism ignores reality: U.S. corporate giants must sell globally to spread the high costs of pioneering research and development outlays. To serve world markets, they must invest globally. It makes no sense for the U.S. government to cut the wings of its strongest firms by deliberately exposing them to capricious foreign governments.

Aside from these bogus criticisms, a legitimate complaint about the ISDS system is closed hearings. Some degree of confidentiality may be required, especially when business secrets are involved, but the ISDS system has gone too far. The U.S.–Mexico ISDS provisions embrace transparency standards identical to those in the Comprehensive and Progressive Trans Pacific Partnership, and this may be an improvement.

Another legitimate complaint is the absence of appellate review, which is available only in extreme cases when arbitrators make clear errors of law or award compensation not supported by the facts. Systematic appellate review would ensure more-uniform decisions when facts and law are similar. But the United States is satisfied with the outcome of prior ISDS cases (16 wins, zero losses), so this is not a priority.

At a time when the Trump administration is hammering China to demand fair treatment to U.S. firms, it's simply bizarre that the administration is sending Congress a USMCA text that guts the ISDS system. It's even more bizarre that the USMCA model for investment is intended as a template for future agreements with Japan, the United Kingdom, the European Union, and others.

With Democrats in control of the House Ways and Means Committee, it's unlikely that ISDS will feature prominently in their grievances about USMCA. But Republicans control the Senate Finance Committee, whose chairman, Chuck Grassley, should be loud and clear in voicing the party's objections. Grassley and his fellow committee members should forcefully insist, with Ambassador Lighthizer in the hearing room, that the committee will not accept similar treatment in future agreements negotiated by the Trump administration.