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# To Save NAFTA, Kill Its Controversial Dispute Settlement Provisions

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"Mystifying." "De facto withdrawal." "Poison pills." That's how *U.S.* policymakers and stakeholders characterize recent U.S. proposals in the North American Free Trade Agreement negotiations. The Canadians and Mexicans are scratching their heads, too.

Team Trump's demands for minimum U.S. content thresholds and a tightening of the rules of origin in both the automobile and apparel sectors would raise the cost of NAFTA compliance, thus driving auto production away from the region and reducing Mexican demand for U.S. textiles. A proposed sunset clause, which would effectively make NAFTA a provisional agreement subject to constant rule changes and the specter of summary termination, would deter investment in cross-border relations, as businesses looked outside the region for greater certainty.

While it is unclear whose interests the Trump administration presumes to be representing, its unorthodox demands derive from the misguided views that trade is a zero sum game—where winning requires that exports exceed imports—and that trade agreements should not just establish the rules, but guarantee particular outcomes. Convincing Trump's trade officials of the fundamental errors in these premises may be too heavy a lift, but they will have to be persuaded to drop these unrealistic demands if NAFTA's demise is to be avoided.

U.S. negotiators should offer to drop their rules-of-origin and sunset provision demands in exchange for agreement to expunge the controversial dispute settlement provisions under Chapters 11 and 19. These provisions are unnecessary, raise fundamental questions about sovereignty and constitutionality, and fuel trade agreement opposition on both the political left and right.

Chapter 11 deals with so-called investor protections. Investor-state dispute settlement (ISDS) provisions are intended to ensure that foreign investors—usually companies that have acquired or established operations abroad—are protected from actions or policies of the home government that fail to meet certain standards of treatment and that cause the investor economic harm. 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.

Of course, business *wants* investor protections. But does business really need these protections? As U.S. Trade Representative Robert Lighthizer put it last week: "It's always odd to me when the business people come around and say, 'Oh, we just want our investments protected.' … I mean, don't we all? I would love to have my investments guaranteed. But unfortunately, it doesn't work that way in the market." He's right.

The fact is that governments are competing to attract investment to keep their citizens employed and their economies growing. Most find it imperative to maintain smart, transparent, predictable policies that are administered fairly and without discrimination. Asset expropriation (which is rare) and other forms of shabby treatment are unlikely to be rewarded by new investment. That doesn't guarantee that policies will never go astray. Sometimes they will. But investment is a risky proposition. Foreign investment is riskier still. That doesn't justify institutions that protect companies from the consequences of their business decisions. International investors are among the most successful and sophisticated companies in the world and are quite capable of evaluating risk and determining whether the expected returns cover that risk.

Providing assurances—outside of private insurance—amounts to socializing the risks of foreign direct investment. When other governments concede to demands for investor protections in trade agreements, they may be less willing to agree to other reforms, such as greater market access, that would benefit other U.S. interests. That is effectively a cost borne by those who don't benefit from the investor protections. Granting foreign companies reciprocal rights to challenge U.S. laws and regulations outside the U.S. legal system also imposes costs on outside parties, including U.S. companies that only have recourse to the domestic legal system; U.S. citizens whose laws and regulation may be challenged extra-judicially; and taxpayers who may be on the hook to compensate foreign companies that win judgments in these cases.

It turns out that ISDS is a subsidy for some companies and a tax on everyone else. It subsidizes risk averse behavior at the expense of essential risk-taking behavior. What may be too risky a 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—generally, incumbent firms—and a tax on younger, more dynamic, more innovative firms.

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, which encourages investment to leave or bypass the United States. How do we justify policies that prioritize concerns for the operations of U.S. companies abroad over the concerns of U.S. and foreign companies' operations in the United States? While we should not denigrate, punish, or tax foreign outsourcing, neither should we subsidize it. ISDS subsidizes outsourcing.

Ambassador Lighthizer has expressed the desire to win support for NAFTA from both Democrats and Republicans—a goal that has been elusive and could go a long way toward restoring pro-trade attitudes. Dropping Chapter 11 would certainly make the deal more appealing to the left. One persistent myth that resonates on the left and has proven hard to dispel is that trade benefits primarily large corporations at the expense of small businesses, workers, taxpayers, public health, and the environment. But trade is the ultimate trust-buster, 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 they devote higher shares of their spending. By granting special legal privileges to multinational corporations, ISDS reinforces that myth and engenders opposition to trade liberalization.

Trade skeptics on the right often assert that trade agreements usurp U.S. sovereignty—that important matters of economics affecting countless Americans are decided by faceless, unaccountable, bureaucrats in some foreign capital. NAFTA Chapter 19 is a case in point. Its provisions govern resolution of antidumping and countervailing duty disputes arising from domestic agency decisions in binational panels composed of trade law experts from both countries, rather than in the domestic courts. It is almost assuredly unconstitutional. In our system of separated powers and checks and balances, the U.S. courts are the only institutions authorized to review and determine whether an administrative action is inconsistent with the law. There have been a few court challenges arguing that Chapter 19 is unconstitutional, but those cases were dismissed over matters of legal standing.

The premise behind the advent of, and continued Canadian support for, Chapter 19 (which originated as a Canadian demand in the Canada-U.S. Free Trade Agreement before becoming enshrined in NAFTA) is that the U.S. courts might not be objective in adjudicating these disputes. But the evidence suggests otherwise.

The U.S. Court of International Trade (CIT), which hears appeals of Commerce Department and U.S. International Trade Commission decisions filed by domestic and foreign interests, has done a good job reining in wayward agency actions over the years. A review of the most recent 18 months of CIT case decisions indicates that the court agrees with the plaintiff (the party challenging the agency's actions) on 46 percent of the issues raised. When the plaintiff is the U.S. industry (objecting to DOC or ITC decisions in the underlying AD or CVD case), the CIT agrees on 43.2 percent of the issues. When the plaintiff is the foreign interest (foreign producer or exporter), the CIT agrees on 47.2 percent of the issues.

Those results suggest that foreign industry plaintiffs have a slightly higher success rate than U.S. industry plaintiffs, which may reflect the fact that agency discretion is more often exercised in a way that is adverse to the foreign interests. An examination (published in a 2006 Cato paper) of the 18-month period between January 2004 and June 2005 found that the CIT remanded 19 cases to the Commerce Department with instructions to revisit its decisions or recalculate its antidumping results. In 14 of those 19 cases, the recalculated dumping margins were smaller, suggesting a higher incidence at Commerce of exercising its discretion to the detriment of the foreign or importing interests.

The U.S. courts are not the problem. The problem is with the laws' administration at Commerce (and to a lesser extent at the U.S. International Trade Commission), which is given way too much discretion for an agency with an overtly protectionist agenda. Thus, Chapter 19 is a solution in search of a problem.

Despite these facts, Canada appears unwavering in its support of Chapter 19. Maybe Ottawa's concern is not that it doesn't get a fair shake from the U.S. courts, but that it gets better outcomes from the NAFTA panels—a conclusion that wouldn't sit well with those concerned about sovereignty because it suggests the panels may be using a less deferential standard of review than the U.S. courts. But, the fact is that the trade agencies are likely to be more responsive to U.S. courts than to NAFTA panels. Certainly, the agencies tend to invoke the sovereignty card and drag their feet when dealt remands from the NAFTA panels. In the longest-running, U.S.-Canada trade dispute of all time—Softwood Lumber—both the Commerce Department and the International Trade Commission refused to implement instructions from the NAFTA panels that would have terminated the antidumping case in 2005. Instead, a deal was struck and Canadian lumber in the United States continues to remain restricted to this day.

These aren’t the only controversial issues in the NAFTA talks. But they are big and important and a good place to begin thinking about the inevitable political and economic compromises that will be needed to save and improve NAFTA.

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