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The Rhetoric and Reality of ISDS

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he coming debate over the Trans-Pacific Partnership (TPP), one of the most controversial issues is likely to be Investor–State Dispute Settlement (ISDS), a legal mechanism in many trade agreements and investment treaties by which foreign investors can sue host governments in an international tribunal. For lawyers who specialize in these issues, the rhetoric about ISDS can be extremely frustrating. Critics make exaggerated claims, such as the assertion that ISDS allows lawsuits whenever investors can show that a law “could hurt expected future profits,” while supporters make it sound like ISDS addresses only laws that discriminate against foreigners. Both arguments are misleading.

ISDS provisions vary a bit across the thousands of treaties that include them, but generally speaking, here’s how they work. Foreign investors can sue host governments for various actions taken by those governments, the most prominent of which are expropriation, nationality-based discrimination, and treatment that falls below a “minimum standard.”

Expropriation is familiar to anyone who has studied U.S. constitutional law, with its takings clause in the Fifth Amendment. In the context of international investment law, the expropriation rules are similar.

The non-discrimination provisions prohibit government actions that discriminate against foreign investors as compared with domestic investors, or against investors from one nation as compared to those from another nation.

Finally, the “minimum standard of treatment” obligation covers a variety of government behavior. It is often elaborated with the term “fair and equitable treatment,” and it covers government behavior that is arbitrary, manifestly arbitrary, or outrageous, depending which treaty is at issue and which tribunal is hearing the case.

If the foreign investor proves that a host government has violated one of these obligations, there will then be a determination of how much economic harm the investor has suffered as a result.

With this legal framework in mind, how do we think about the value of ISDS as a policy matter?

Supporters see ISDS as a way to promote the rule of law and encourage international investment. Many countries around the world, they say, lack basic protections of the sort provided by ISDS. Where governments cannot offer these, ISDS can step in to provide an external legal system,

thereby reassuring investors and making them feel better about investing in poor but unstable countries that desperately need the investment.

There is a grain of truth to this argument. However, the historical background tells a more complicated story, and empirical evidence does not clearly support the argument about increased foreign investment.

At the end of the colonial era, following World War II, there was a wave of expropriation of foreign investment by newly independent, nationalist governments. This was of great concern to Western companies, and they found a solution in investment treaties, which would allow affected companies to argue for compensation in a neutral forum.

Today, though, the world of foreign investment is a very different place. Expropriations have fallen from around 40 per year in the 1970s to 3 or 4 per year recently. Instead, many governments now lavish subsidies on foreign investors rather than treating them badly. There is a global competition for foreign investment, and big companies are the beneficiaries.

Yet ISDS remains and has proliferated. Business groups like having the option to sue and have pushed hard to keep it, even though the original rationale often does not apply. ISDS has even become a part of treaties between countries that have strong domestic rule of law.

Legal scholars and policy wonks have been talking about ISDS for years. With trade agreements such as the TPP up for debate, the controversy over ISDS has now been brought into the public eye, offering a great opportunity to think about how we should approach ISDS.

The main protections of international investment law, described above, are nothing radical. They are commonly found in domestic law. What is radical is that ISDS provides a basis for claims by individuals under international law. That is not the norm in international law, which generally relies on government-to-government claims. What you have with ISDS, in effect, is a great expansion of the enforceability and effectiveness of international law, for the benefit of one group: foreign investors.

That creates a perception of unfairness. To be sure, we might want to offer such international rights to various people. But if we did, foreign investors are not the obvious place to start.

Significantly, many concerns about ISDS could be reined in with modest tweaks, such as removing the “fair and equitable treatment” provision. This is a broad and vague obligation that allows companies to bring a very wide range of claims. A simple reformulation of international investment law, to focus it on discrimination based on nationality, would center these obligations more firmly in the international economic-relations issues that they supposedly address.

But more fundamentally, we should rethink the need for the system. These treaties were designed to address a problem from decades ago that is fading from memory. What, if any, problems arise with foreign investment today? The most prominent one is probably lavish subsidies from governments that are regularly given to foreign investors, and international limits on such practices could be of value.

As Congress considers the TPP, probably sometime in the next year, it should think deeply about what to do with ISDS. Often policy seems to just get carried over from a prior template.

However, as conditions change, we should be flexible enough to design new policies that match our current needs.

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