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Investor-State Dispute Settlement (ISDS) Mechanisms: An Important Feature of High-Quality Trade Agreements

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One of the most important—albeit controversial—components of the proposed Transatlantic Trade and Investment Partnership (TTIP) trade agreement between the United States and the European Union (EU) is the provision creating an investor-state dispute settlement (ISDS) mechanism. The French Senate has unanimously called for the removal of this provision both from the TTIP and from a separately concluded EU trade agreement with Canada, and many other European organizations have raised similar objections.¹

There are many reasons to doubt that a trade agreement between the U.S. and the EU will deliver the economic gains or advance the broader geopolitical objectives claimed for it. Like any treaty, a trade agreement can be fairly assessed only when a full and final text has been negotiated and presented to the public. Yet the concerns raised in principle about creation of an ISDS mechanism are unfounded. Far from being dangerous or undesirable, an appropriately structured ISDS is an essential part of trade-agreement enforcement and should be included in any U.S. trade agreement with the EU.

The Basic Protections of ISDS Mechanisms

ISDS mechanisms exist to secure basic legal protections for a signatory state's nationals abroad. Four basic protections are central to ISDS mechanisms:

- **Minimum standards of treatment.** Host nations must provide investors with fair and equitable treatment and full legal protection and security, either as defined by the agreement or as limited to the international minimum standard.
- **Due process.** Nations must follow defined and legal processes. They may not invoke arbitrary measures in cases involving investors from another nation.
- **Non-discrimination.** The protections for foreign investors must be the same as those for domestic investors. Moreover, the most favored nation standard² mandates that host states may not discriminate between foreign investors from different nations.
- **Expropriation.** Nations cannot directly (e.g., by nationalization), indirectly (e.g., by breaking a contract or in other circuitous ways), or “creeping” (e.g., by gradual means) render an investment valueless without compensating the investor.

ISDS mechanisms can allow foreign claimants wronged under the agreement to take their claim directly to the international investment tribunal forum provided by the treaty, therefore avoiding the local, cumbersome, and often corrupt remedies of domestic courts. ISDS mechanisms can also be structured to supplement domestic legal systems by requiring investors to exhaust their remedies in those systems first. This kind of mechanism is more appropriate for agreements between law-abiding nations

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because it gives investors a way to appeal to an agreed system of international arbitration for disputes, while simultaneously respecting national legal systems.

The Advantages of ISDS Mechanisms

ISDS mechanisms are designed to safeguard fair, unbiased, and transparent legal processes by providing for independent and impartial arbitration. Because they work quickly, they ensure that disputes are addressed in a systematized, predictable, and consistent way so that the investment function and capital flow may continue while according the claimant the relief that is due. Without ISDS mechanisms, the investment-related aspects of the TTIP would become moot and academic. That is why arbitration is part of the World Trade Organization (WTO) and of many bilateral and multilateral treaties to which the U.S. and the various EU member states are signatories. ISDS mechanisms are neither novel nor untried.

In 2013, the U.N. found that ISDS mechanisms had been used, as of the end of 2012, in 514 known cases. Claims are most commonly filed against authoritarian or autocratic regimes: Argentina, Venezuela, and Ecuador are the three most frequent respondents, comprising 109 of the known cases. However, claims have also been filed against the U.S. and the EU member states: NAFTA (49 cases) and the EU's Energy Charter Treaty (29 cases) are the most commonly used instruments for ISDS claims.³

There is no reason why the stipulations and terms of the TTIP's ISDS provisions should not resemble the ISDS provisions in other trade agreements to which the U.S. and the EU are already signatories, including the WTO. Agreements containing ISDS mechanisms protect the rights of governments to regulate in the public interest—including on public

health and the environment—so long as they do so without discrimination and do not expose national, state, or local governments to new liabilities, procedures, or penalties that are not already available against them under domestic law.⁴

Arbitration of freely accepted commitments by freely negotiated mechanisms that are limited to the dispute at hand does not undermine national sovereignty any more than arbitration of commercial disputes deprives companies of their freedom to enter into contracts. ISDS provisions merely protect investors when nations insist on undertaking actions in defiance of their freely accepted commitments. Opponents of ISDS provisions do not demand the right to act. They demand the freedom to act without foreseeable consequences.

ISDS mechanisms do not just protect investors. They also promote international investment by ensuring that investments will not be expropriated, and international investment, in turn, promotes growth.⁵ The total amount of inward foreign direct investment increased from 9.7 percent of global gross domestic product (GDP) in 1990 to 34.3 percent of global GDP in 2013 and from 13.4 percent to 33.2 percent in developing countries—the same period when the world was increasingly negotiating trade agreements containing arbitration provisions.⁶

The Fifth Amendment to the U.S. Constitution provides: “No person shall be...deprived of...property, without due process of law; nor shall private property be taken for public use without just compensation.” That is the essence of ISDS mechanisms. Even for trade agreements between law-abiding democracies, there must be predictably enforceable ways for the signatories to avail themselves of their rights, so that they are fairly available to all signatories. That is the core purpose of ISDS mechanisms.

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1. EurActiv, “French Senate Tells TTIP Negotiators to ‘Abolish’ ISDS,” February 4, 2015, <http://www.euractiv.com/sections/trade-society/french-senate-tells-ttip-negotiators-abolish-isds-311823> (accessed February 13, 2015).
 2. Since 1998, the “most favored nation” standard has been known in the U.S. as “permanent normal trade relations.”
 3. U.N. Conference on Trade and Development, “Recent Developments in Investor–State Dispute Settlement (ISDS),” *IIA Issues Note* No. 1, May 2013, http://unctad.org/en/PublicationsLibrary/webdiaepcb2013d3_en.pdf (accessed February 13, 2015).
 4. For example, see Agreement Establishing the ASEAN-Australia-New Zealand Free Trade Area, chap. 11, Annex on Expropriation and Compensation, February 27, 2009, <http://www.asean.fta.govt.nz/chapter-11-investment/> (accessed February 13, 2015).
 5. For example, see Eric Neumayer and Laura Spess, “Do Bilateral Investment Treaties Increase Foreign Direct Investment to Developing Countries?” *World Development*, Vol. 33, No. 10 (October 2005), pp. 1567 and 1582, and Jeswald W. Salacuse and Nicholas P. Sullivan, “Do BITs Really Work?: An Evaluation of Bilateral Investment Treaties and Their Grand Bargain,” *Harvard International Law Journal*, Vol. 46 (Winter 2005), pp. 67 and 105. See also Office of the U.S. Trade Representative, 2012 U.S. Model Bilateral Investment Treaty, arts. 24 and 37, <http://www.ustr.gov/sites/default/files/BIT%20text%20for%20ACIEP%20Meeting.pdf> (accessed February 13, 2015).
 6. See U.N. Conference on Trade and Development, *World Investment Report 2014*, 2014, Annex Tables, <http://unctad.org/en/pages/DIAE/World%20Investment%20Report/Annex-Tables.aspx> (accessed February 13, 2015).

The Left's Criticism of ISDS Mechanisms

Although the AFL-CIO strongly opposes inclusion of an ISDS mechanism in the TTIP, most criticism of ISDS mechanisms has come from Europe.⁷ The EU Commission's negotiating mandate for the TTIP included creation of an ISDS mechanism, but in January 2014, public hostility forced it to take ISDS off the negotiating table.⁸

Later that year, a public consultation conducted by the EU Commission resulted in over 150,000 replies, the most the Commission has ever received in such an exercise. Almost 90 percent of respondents rejected inclusion of an ISDS mechanism in the TTIP. The campaign against ISDS was led, through a sophisticated public relations campaign, by left-wing nongovernmental organizations such as Friends of the Earth and European trade unions—groups that are savvy in the ways of social media.⁹ The recent action by the French Senate shows that the European criticism of inclusion of ISDS provisions in the TTIP has not abated.

Some trade unions in both the U.S. and the EU want a regulation-heavy deal that protects today's union workers at the expense of everyone else today and tomorrow, while at the same time opposing legal protections for foreign investors. The environmental left is simply opposed to trade agreements as such, viewing them as instruments of "the interests of international capital."¹⁰ That attitude condemns billions of people to poverty. The stance of these groups and the political support it has garnered send a discouraging signal about the prospects of negotiating a high-quality TTIP.

What the U.S. Should Do

One of the purported purposes of the TTIP is to serve as a model for future trade agreements.¹¹ That is all the more reason why any trade agreement between the U.S. and the EU should be a high-quality

agreement. To be worthy of being called a free trade agreement, a TTIP must not lead to increased or harmonized regulation. It must also contain ISDS provisions that respect national legal systems, are carefully limited to the dispute at hand, and will allow the commitments in the agreement to be enforced fairly in all signatories. An agreement that lacks such provisions would be a bad deal for the U.S. now and a bad model for U.S. trade diplomacy in the future.

Treaties are how civilized nations do business. Today, too many treaties are negotiated and signed but not upheld. But, by and large, trade agreements have been upheld, at least in part because the mutual benefits that they offer are covered by ISDS mechanisms. This incentivizes all parties to uphold their freely accepted commitments. A trade agreement between the U.S. and the EU would be the largest in history. The U.S. cannot accept such an agreement if it does not verifiably reduce government involvement in trade. Such an agreement would be a backward step for freedom.

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7. AFL-CIO, "U.S.-EU Free Trade Agreement (TTIP)," <http://www.aflcio.org/Issues/Trade/U.S.-EU-Free-Trade-Agreement-TTIP> (accessed February 13, 2015).
 8. EurActiv, "ISDS Decision Delayed to End of TTIP Talks," January 13, 2015, <http://www.euractiv.com/sections/trade-society/isds-decision-delayed-end-ttip-talks-311234> (accessed February 13, 2015).
 9. Ibid.
 10. Friends of the Earth, "The World Trade Organization," 2015, <http://www.foe.org/projects/economics-for-the-earth/trade/WTO> (accessed February 13, 2105).
 11. For example, see John Kerry, "On the Occasion of Europe Day," U.S. Department of State, May 8, 2014, <http://www.state.gov/secretary/remarks/2014/05/225839.htm> (accessed July 7, 2014), and Sean Hackbarth, "Chancellor Merkel: Transatlantic Trade Agreement Would Energize Global Economy," U.S. Chamber of Commerce, May 2, 2014, <https://www.uschamber.com/blog/chancellor-merkel-transatlantic-trade-agreement-would-energize-global-economy> (accessed July 7, 2014).