Why Do Countries Commit to ISDS for Disputes with Foreign Investors?

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Introduction

No matter how attractive a foreign investment opportunity appears to be, government intervention post-investment can alter the sustainability and profitability of the project. Host country political events, economic crises, and social factors can induce governments to change domestic regulations, revoke licenses, withdraw subsidies, deviate from contract terms, alter tax rates, or expropriate foreign investments. In recent years, foreign investors have discovered a potent tool, the investor–state dispute settlement (ISDS), to address disputes arising from actions of host governments. Disputes between foreign firms and host governments—which might otherwise be settled through diplomacy, informal means, or domestic courts—can now be settled by an arbitration tribunal outside the jurisdiction of the host country. By 2014, there were over 600 treaty-based claims brought by foreign investors against both developed and developing countries (World Investment Report, 2015). They have sometimes proved to be extremely costly for host governments, often in sensitive areas of regulation, making investor–state arbitration one of the most controversial aspects of global economic governance.

What Is ISDS?

ISDS is a procedure to resolve disputes between foreign investors and host governments. Foreign investors facing disputes with the host government may be concerned about getting a fair trial in a host country against the government. The ISDS system allows foreign investors to seek redress in a neutral international arbitration forum. Investors often gain this right through clauses enshrined in bilateral investment treaties (BITs) or free trade agreements.

In order to bring a case forward, the foreign investor must claim that the host country breached rules established in the agreement (e.g., uncompensated expropriation, breach of contract). Once arbitration is initiated, a tribunal is formed. The focus of the tribunal is usually on the request of the plaintiff for a monetary award. If the panel rules in favor of the plaintiff, it must also determine the amount of the award. Generally, ISDS panels do not overturn domestic laws or regulations; rather they are limited to providing compensation for loss or damage of investment. Unlike domestic courts, states have little control over the process or final decision of the international arbitration tribunal. Decisions have limited avenues for appeal and cannot be amended by the domestic court system or legislation. The ability to make claims against host country governments in front of tribunals is a major departure from conventional international law and significantly expands the rights of MNCs.

International arbitration is typically structured by the rules established by the International Center for Settlement of Investment Disputes (ICSID) or the UN Commission on International Trade Law (UNCITRAL). The firm's home government need not be involved in this process and may not even know when or how foreign investors challenge host governments.

Why Commit to ISDS?

Host governments have, in effect, constrained their policy space and ceded aspects of their own sovereign immunity by giving foreign investors access to ISDS. Why have so many governments signed treaty clauses that could hurt them? I will explore three potential explanations for the rise of ISDS.

Attracting FDI through Credible Commitments

One mechanism by which host governments can credibly indicate that they will not expropriate foreign investors (or adopt other value-decreasing policy changes post-investment) is by tying their own hands upfront. In other words, if host governments design a system that makes it costly for them to expropriate foreign investors, then the interests of foreign investors and host governments are aligned, thus improving the country's credibility in the eyes of foreign investors. ISDS allows governments to signal such a commitment.

ISDS increases the costs of expropriation by making host governments vulnerable to significant economic payoffs. If the arbitration tribunal rules in favor of the foreign investor, the host government may face large financial liabilities. In addition, this may convey negative information to a broader investment community, discouraging potential foreign investors from choosing the host country for their investments. Thus, including ISDS clauses in international investment agreements may help to constrain the state's policy discretion and make credible commitments to foreign investors.

Some studies have shown that developing countries commit to ISDS by signing Bilateral Investment Treaties (BITs) when their competitors for FDI have done so (Guzman, 1998; Elkins, Guzman, & Simmons, 2006), when they face economic slowdowns (Simmons, 2014), or under conditions of capital scarcity, for example, facing high US interest rates and net external financial liabilities (Betz & Kerner, 2015). Further, countries facing ISDS cases or those losing a dispute suffer notable FDI losses (Allee & Peinhardt, 2011).

Less clear, however, is whether commitment to ISDS actually results in greater FDI inflows. A large body of empirical literature testing the relationship between BITs and FDI inflows reveals inconclusive and conditional results (see, for example, Kerner, 2009; Hallward-Driemeier, 2009; Jandhyala & Weiner, 2014). Thus, it is unclear if foreign investors view ISDS as credible mechanisms by which governments can effectively tie their own hands.

Arising from Unintended Policy

A second explanation for the rise of ISDS suggests that host governments, especially in developing countries, signed away sovereignty without recognizing the implications of their actions. During the 1990s, about 100 BITs were being signed each year. Research suggests that these treaties were not carefully considered for their benefits and costs, and there was no political awareness of what governments were signing. Rather, following neoliberal reforms many countries adopted ISDS to demonstrate that they were adhering to what had become widely accepted as a global standard or norm about the treatment of FDI as established by international organizations and Western states (Jandhyala, Henisz, & Mansfield, 2011).

Without significant discourse, the treaties were simply assumed to be a piece of paper to be signed and a good photo opportunity for a visiting dignitary. As a former South African official remarked, "we were essentially giving away the store without asking any critical questions or protecting crucial policy space" (Provost & Kennard, 2015). The potential downside, like other low-probability, high-risk events, was completely downplayed and not realized until the country was sued for the first time by a foreign investor (Poulsen, 2014). Take, for example, the case of Pakistan. As Poulsen and Aisbett (2013) document, when the country was sued for the first time by a Swiss investor, the claim took the Pakistani bureaucracy by complete surprise. Pakistan's Attorney General, an expert on international public law, had to look up "BITs" and "ICSID" on Google. There were no records of Pakistan's BIT negotiations with Switzerland in any of the relevant ministries, and a copy of the treaty had to be requested from Switzerland. Thus, evidence suggests that signing up to ISDS may have also been unintended or uninformed.

Resolving Investment Conflicts without Creating Political Conflicts among States

A third argument suggests that government consent to ISDS was an attempt to de-politicize disputes. Prior to the establishment of the ISDS system, foreign investors often relied on diplomatic protection to secure their investments abroad. This resulted in gunboat diplomacy—with diplomatic and military intervention in defense of private investors—which could compromise the home country's foreign policy objectives.

The history of US government intervention in commercial disputes abroad during the 20th century provides a classical example. Maurer (2013) notes that US sugar firms lobbied the US government to cut Cuba's sugar quotas in response to Cuban initiated land reforms in the 1950s and 1960s. Although officials noted that "keeping Cuba out of the Sino-Soviet orbit … is more important than salvaging of U.S. investments in Cuba" (Maurer, 2013: 322), under pressure from private investors, the US nonetheless blocked the entry of Cuban sugar into the US. The result was a foreign policy disaster as Cuba moved further into the Soviet orbit. Similar narratives in other countries (e.g., Brazil, Indonesia) suggest that while US investors almost always managed to receive fair compensation from expropriating foreign governments through such diplomatic interventions, US foreign policy objectives were compromised.

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Wouldn't it be better if home governments could separate commercial disputes from foreign policy objectives and direct investors to an alternate system of dispute resolution that doesn't rely on diplomatic intervention? ISDS was that system. It allowed a home government to direct investors to a legal process while credibly denying them diplomatic support. They could call back their gunboats and diplomats, while still providing significant rights for investors.

Or could they? Recent research suggests that we should at least consider this explanation more critically. The findings suggest that although few recent disputes invoke explicit threats of sanctions from home governments, investment disputes are not insulated from diplomatic intervention and access to ISDS has no substantial impact on the likelihood of home country diplomatic intervention in a dispute between foreign investors and host governments (Jandhyala, Gertz, & Poulsen, 2015). Similarly, diplomatic intervention by the Spanish Government continued in response to Argentina's nationalization of Repsol—the Spanish oil company—even while the company sued under the Spain–Argentina BIT.

Conclusion

ISDS continues to be controversial in both developed and developing countries. Recent cases have highlighted the broad scope of these rights. For example, Philip Morris sued Uruguay and Australia for their anti-tobacco regulations, and Sweden's energy company Vattenfall sued Germany for regulations phasing out nuclear power. Countries such as South Africa, Indonesia, and India—which found themselves at the receiving end of recent claims—are examining ways to restrict investor rights. And notwithstanding the recent signing of the Trans-Pacific Partnership (which includes an ISDS clause), opposition to ISDS continues in the US and in the EU (which is negotiating its own trade agreement with the US, the TTIP).

Some of the opposition is focused on the arbitration process itself—for example, should it be secret, decided by commercial lawyers acting as arbitrators in cases involving public policy, where the rights are one-sided? Others argue that investor rights are too broad causing a chilling effect on government policy. Yet others suggest that ISDS is a weak bargain—that states accept significant constraints on sovereignty for little in terms of returns. It is clear that ISDS is not a perfect solution. But as long as FDI continues, there will be disputes between foreign investors and host governments which need to be settled. Identifying a middle path is the challenge of the next decade.

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