

The ISDS Reform Process: The missing development agenda

By Nicolás M. Perrone*

The foreign direct investment (FDI) governance agenda is centred on the reform of international investment agreements (IIAs) and investor-state dispute settlement (ISDS). This is a rule of law-based discussion shaped by the concerns of foreign investors: i.e. political risk and the protection of foreign investor rights. The significance of this debate is not only determined by the institutional options under consideration, e.g. the creation of a permanent court or an appellate mechanism (Puig and Shaffer, 2018). Focusing on dispute settlement also shifts the attention away from a more holistic approach to FDI. The proliferation of IIAs and ISDS have contributed to narrowing the FDI agenda, removing issues such as control, balance of payments, labour, taxation and information sharing from the discussion. A key policy question is whether this fragment-

ed approach remains consistent with the 2030 Sustainable Development Goals (SDGs).

Current FDI discussions point at the need for a holistic approach in this policy area. The SDGs rely on multi-stakeholder partnerships to combat poverty and provide clean water and energy to the world population. For the United Nations, partnerships are the best strategy to mobilise resources and support the achievement of the SDGs. Crucially, these partnerships will require more cooperation and coordination relating to states' policy space and the relationship between FDI and domestic laws and policies. The discussions for an investment facilitation framework have also highlighted the importance of this development dimension. 'Investment facilitation is "for develop-

Abstract

The foreign direct investment (FDI) governance agenda is centred on the reform of international investment agreements (IIAs) and investor-state dispute settlement (ISDS). The proliferation of IIAs and ISDS has contributed to narrowing the FDI agenda. A key policy question is whether this fragmented approach remains consistent with the 2030 Sustainable Development Goals (SDGs). Current FDI discussions point at the need for a holistic approach in this policy area, quite the opposite of a regime primarily aimed to protect foreign investors through treaty standards and international arbitration. The realisation of the SDGs depends on multi-stakeholder partnerships to combat poverty and provide clean water and energy to the world population. Crucially, these partnerships will require more cooperation and coordination than IIAs and ISDS can promote and nurture.

Les programmes de gouvernance sur les investissements directs étrangers (IDE) sont centrés sur la réforme des accords internationaux d'investissement (AII) et des mécanismes de règlement des différends entre investisseurs et États (en anglais Investor-state dispute settlement, ISDS en abrégé). La croissance exponentielle de ces accords et de ISDS a contribué à limiter la réflexion à ces deux aspects. La question essentielle qui se pose, du point de vue politique, est de savoir si cette approche étroite reste compatible avec les objectifs de développement durable pour 2030. Les discussions actuelles sur les investissements directs étrangers soulignent la nécessité d'une approche globale dans ce domaine, tout à fait à l'opposé d'un régime visant principalement à protéger les investisseurs étrangers par des normes conventionnelles et un système d'arbitrage international. La réalisation des objectifs de développement durable passe par la mise en place de partenariats multipartites permettant de lutter contre la pauvreté et de fournir de l'eau et de l'énergie propres à la population mondiale. Ces partenariats doivent impérativement s'appuyer sur une approche qui, bien plus que les AII et le ISDS, favorise et facilite la coopération et la coordination entre les différents acteurs.

La internacional agenda sobre inversión extranjera directa (IED) se centra en la reforma de los acuerdos internacionales de inversión (AII) y en la solución de controversias entre inversores y Estados (ISDS, por sus siglas en inglés). La proliferación de los AII y de ISDS ha contribuido a reducir la agenda sobre IED. Una cuestión de política clave es si este enfoque fragmentado es coherente con los Objetivos de Desarrollo Sostenible (ODS) para 2030. Los debates actuales sobre IED señalan la necesidad de adoptar un enfoque holístico sobre estas políticas, lo que supone lo contrario a un régimen destinado principalmente a proteger a los inversores extranjeros mediante tratados y arbitraje internacional. El cumplimiento de los ODS depende de asociaciones de múltiples partes para combatir la pobreza y proporcionar agua limpia y energía sustentable a la población mundial. Fortalecer estas asociaciones requiere un nivel de cooperación y coordinación mayor que los AII y ISDS son capaces de promover.

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ment''' (Sauvant, 2019, p. 2).

In this new context, the methodological *bracketing* promoted by IIAs and ISDS may be something worth reconsidering. Historically, the position of the United Nations has been that FDI can be simultaneously an effective instrument of development and a source of tension or conflict (UNDESA, 1974, p. 6). The members of the Group of Eminent Persons observed in 1974 that FDI has many ramifications and touches 'upon many aspects of the economic and social life throughout most of the world' (UNDESA, 1974, p. 15). Following this diagnosis, the FDI governance agenda was quite ambitious. It included the negotiation of a code of conduct for states and multinational corporations and the creation of a general agreement on multinational corporations similar to the General Agreement on Tariffs and Trade (GATT) (UNDESA, 1974, p. 7).

For developing countries, this holistic approach to FDI was and remains a top priority. Governments have the dual mission to attract FDI into their countries and to create a regulatory framework capable of maximising the benefits while minimising the costs and risks of these capital flows (Sagafi-nejad and Dunning, 2008, p. 51). This delicate balance has shaped their position on multinational corporations at the United Nations and other international organizations for decades. Developing countries require policy space to ensure reasonable benefits for the host country, including measures such as screening and approval, technology transfer or performance requirements (Correa and Kumar, 2003, p. 23). They also need to ensure that the costs and risks of FDI will not outweigh the benefits. Unsustainable FDI can become a political disaster.

Importantly, domestic law may not be enough to address this significant risk. The Group of Eminent Persons observed that governments have the primary responsibility for multiplying the benefits and reducing the costs of FDI. At the same time, they highlighted that 'many of the measures that we think necessary will be ineffective and frustrated unless they are accompanied by action at the international level' (UNDESA, 1974, p. 51).

In the 1990s, the Washington consensus resulted in action at the international level, but aimed to narrow down the FDI governance agenda. This agenda was all about promoting and attracting FDI, in particular, by opening up sectors to foreign firms and creating a friendly investment environment. As a result, measures aimed to increase the benefits of FDI for host countries were regarded as undue interventions to market forces. Governments were asked to promote linkages with the domestic economy but not to interfere with FDI – either directly or indirectly (UNCTAD, 1992, p. 100; UNCTAD, 1996, p. 191). Similarly, regulations to curb the costs and risks of FDI were deemed necessary sometimes, but ultimately discouraged due to the risks of public abuse and arbitrary behaviour (UNCTAD, 1999, pp. 174-6, 325).

This minimalistic approach to FDI governance crystallised with the ratification of thousands of IIAs in the 1990s. These treaties not only protect FDI from regulatory measures, but also have rules prohibiting or hindering screening and approval mechanisms, transfer of funds restrictions, performance requirements or technology transfer. In other words, IIAs contribute to determining a quite specific economic development pathway (Perrone, 2018, pp. 33-4). Other pathways are beyond the pale.

This FDI policy was not a success. Developing countries increased their share of FDI inflows, but there is no evidence that IIAs have influenced this increase (Bellak, 2015, p. 19). In the last three decades, the contribution of FDI to sustainable development also remains debatable. For one, positive spillover effects depend on several factors while these capital flows can also have negative implications, such as crowding out domestic firms (Colen *et al*, 2012). The stock of FDI may not be significant compared to domestic capital, but foreign capital flows can still shape host economies. FDI may define the trade performance of a country, e.g. through global value chains, and states often pay more attention to multinational corporations than domestic firms (Bhaduri, 2002, pp. 36-7). Also, the relationship between FDI and inequality can be problematic (Piketty, 2014, pp. 68, 70, speaking of Africa).

For another, FDI also creates costs and risks and nothing guarantees that host states will deal with them appropriately. To realise the benefits of FDI, countries need to ensure that the benefits outweigh the costs, and that those who suffer unavoidable costs will be appropriately compensated. Regulating and monitoring FDI is then fundamental. But the problem is that some states may lack regulatory capacity or face regulatory chill. Foreign investors may resist the changes of regulations through diplomatic and legal strategies. If the changes are finally implemented, moreover, investors may initiate an ISDS case requesting the review of the new regulation (see, e.g., Tienhaara, 2011; Bonnitcha *et al*, 2017, pp. 141-8). These disputes have sparked significant controversy, as developed and developing countries have seen their policy space to promote the public interest somewhat restricted. Some of these cases involve the 2001 Argentine economic crisis, South African Black Economic Empowerment Laws or tobacco control regulation in Australia and Uruguay.

None of this evidence suggests that FDI cannot contribute to sustainable development. It neither contradicts the case studies showing FDI positive spillover effects. However, it reinforces a premise that most data and case studies support: it depends (Cohen, 2007, p. 332).

The current backlash against IIAs and ISDS, however, does not reflect all the implications associated with the failure of Washington consensus policies. The debate about the states' right to regulate and ISDS has brought some concerns back to the policy agenda. But these discussions focus on the resolution of disputes as opposed to background rules on FDI (see e.g. the United Nations Commission on International Trade Law (UNCITRAL) Working Group III negotiation process, Roberts and St

John, 2019). Those who analyse IIAs as a system, moreover, mainly focus on the implications of ISDS for FDI governance, overlooking the complexity of FDI matters.

From a development perspective, focusing on ISDS removes significant issues from the policy agenda. IIAs and ISDS are relevant not only for what they do but also for how they have reshaped the debate, shifting the attention away from a development-oriented and holistic perspective of FDI governance. The consensus that IIAs and ISDS should provide space for legitimate regulation for the public interest masks the potential for substantial disagreement. Developed countries are primarily concerned with measures aimed to curb negative externalities and market abuse, while developing countries may also refer to a more activist development policy, including measures to increase local content or support national champions (Lang and Perrone, 2017, p. 287).

In this regard, some missing issues for developing countries include:

1. The relationship between FDI, capital controls and IIAs. In the 1990s, IIAs and the policies promoted by the International Monetary Fund (IMF) and other institutions matched each other. This has changed. The IMF is now more open to capital controls (Jeanne *et al.*, 2012, pp. 34-5; Furness, 2019). This discussion brings back to the table a critical issue for the sustainability of FDI in developing countries. While it is true that host states benefit from the inflows of foreign capital, they also need to make a careful assessment of the future outflows of capital as multinational firms will transfer dividends and, eventually, divest (Gallagher and Zarsky, 2004, p. 24).

2. The interplay between IIAs and mechanisms to steer FDI and maximise host countries' benefits. In the 1990s, the policy advice was that states should not interfere with the operation of multinational corporations. Today, this consensus is collapsing too. Developed countries increasingly screen and regulate FDI to make sure it better serves their national interests (UNCTAD, 2019a; UNCTAD, 2019b, p. 84). For developing countries, this trend may signal the need to implement mechanisms to steer FDI flows into specific sectors and activities. These mechanisms may include screening and approval, performance requirements and local content rules, joint ventures, and technology transfer.

3. Technology transfer, moreover, is not only relevant from this economic developmental perspective. Today more than ever, sustainable development requires using the best available technologies to reduce the carbon footprint. Access to green technologies is fundamental to ensure that economic activities in developing countries are as consistent as possible with the climate change agenda.

4. FDI is also related to labour conditions in developing countries. A 2017 International Labour Organiza-

tion (ILO) report shows that the operation of global value chains (GVCs) not only affects local suppliers – illustrating some weakness of the linkages policy – but also salaries and working conditions (ILO, 2017, pp. 3-9).

5. The responsibility of multinational corporations for their actions in host states is another key question that has been overlooked for many years. This issue has gained some visibility with the ongoing negotiations for a binding treaty on business and human rights (Mohamadih 2019). However, it is still uncertain whether this initiative will succeed, and the inclusion of specific foreign investors' obligations in IIAs does not seem to be a realistic policy option in the near future. For aggrieved local actors and developing states, having to litigate these grievances in home states' courts or arbitral tribunals takes the discussion too far from the locality.

6. In one way or another, these issues relate to a common concern reflected in the 1974 Report of the Group of Eminent Persons on FDI. This is the asymmetric bargaining power of multinational corporations and host states (UNDESA, 1974, p. 32). Unequal bargaining power can lead to investment contracts or stabilisation agreements that are not development friendly. The interpretation and enforcement of these agreements, moreover, often lie in the hands of international arbitrators and foreign investors do not need to exhaust local remedies to bring a claim. This type of dispute settlement arrangement removes the matter from domestic laws and institutions, worsening host states' bargaining power.

For developing countries, a holistic discussion of FDI would bring several advantages. It would emphasise the ramifications of FDI visibilising everybody's concerns: i.e. foreign investors, home states, host states and non-state actors. Also, the complexity of FDI matters suggests that a rule of law-based solution may not be enough to govern FDI. More is needed. Governing FDI through IIAs and ISDS corresponds to a policy model discredited by years of social and economic failures. Developing countries should then consider promoting a more holistic FDI agenda based on multi-stakeholder cooperation as much as the rule of law. This agenda should seek the international recognition of mechanisms to ensure that FDI can serve different development strategies.

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While the reform process of international investment protection treaties is evolving, it is still at a nascent stage. Systemic reforms that would safeguard the sovereign right to regulate and balance the rights and responsibilities of investors would require more concerted efforts on behalf of home and host states of investment in terms of reforming treaties and rethinking the system of dispute settlement.

Experiences of developing countries reveal that without such systemic reforms, developing countries' ability to use foreign direct investment for industrialization and development will be impaired.

The policy brief series is intended as a tool to assist in further dialogue on needed reforms.

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