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President Donald Trump has promised to renegotiate the North American Free Trade Agreement (NAFTA), which links the United States with two of its largest trading partners, Canada and Mexico. Officials in both Canada and Mexico have signaled they are open to renegotiations, and talks are expected to begin soon. New commerce secretary Wilbur Ross has indicated he hopes the negotiations could be completed within a year.

While NAFTA is known primarily as a trade agreement, it also includes important rules and regulations for governing cross-border investment between the three countries. NAFTA’s Chapter 11 guarantees investors from any of the three countries several substantive protections for their foreign operations located in a treaty partner, including the right to “fair and equitable treatment,” the ability to transfer profits abroad, and the right to compensation in the event of direct or indirect expropriation (including potentially through regulatory changes). Notably, Chapter 11 also empowers foreign investors to enforce these rights via investor-state dispute settlement (ISDS), a legal mechanism that allows companies to file claims directly against sovereign governments. These cases are heard by private arbitrators, who can issue substantial monetary awards enforceable in almost any country around the world. To date there have been 59 such cases filed under NAFTA: 16 against the U.S., 25 against Canada, and 18 against Mexico. While the U.S. has so far never lost an ISDS case, both Canada and Mexico have lost several, requiring payments to investors of over $100 million.

At this point it is unclear which aspects of NAFTA Trump would like to change, or what requests, if any, Canada and Mexico may bring to the negotiations. Yet there are reasons why all three treaty partners may want to revisit the investor protections included in Chapter 11. In recent years ISDS has become increasingly controversial, as governments have faced a growing number of adventurous legal claims from foreign investors. Investor claims have challenged government policies on issues from mining licenses to the privatization of healthcare to subsidies for nuclear energy. Meanwhile civil society and nongovernmental organizations have sharply criticized the premise of investor-state arbitration, and even pro-globalization advocates such as The Economist have raised serious questions about its merits. Partially as a response to these mounting arbitration cases and public backlash, countries around the world have begun experimenting with new models for governing international investment. The renego-
tiation of NAFTA presents an opportunity to assess some of these new models and consider how they might apply to the North American context.

This brief sketches four broad options for the future of investment protection in NAFTA:

1. Upgrading the treaty’s investment chapter while leaving the main substantive and procedural aspects of investment protection in place.
2. Abandoning legalized treaty-based investment protections, leaving any provisions on investment not directly legally enforceable.
3. Shifting from an investor-state framework to a state-state framework, in which states would be responsible for legal enforcement of investment regulations.
4. Linking NAFTA to the recently proposed multilateral investment court.

The purpose of this brief is not necessarily to advocate for any one of these options over the others, but rather to identify some of the key advantages and drawbacks of each and to encourage a broader debate on the future of investment protection policy. Any renegotiation of NAFTA creates an opportunity to reassess foundational assumptions and arguments on investment protection. While a rich debate surrounding ISDS has arisen in many countries around the world, in the U.S. this discussion has lagged. As a result, investment policy reform in the U.S. has proceeded slowly, while other countries have pushed forward with bold changes.

Trump’s insistence on renegotiating NAFTA, however, is an opening to consider more creative and ambitious proposals. Trump has demonstrated a willingness, in fact even a preference, for questioning the orthodoxy and conventional wisdom of international economic policy. Nowhere is such questioning more needed than in the realm of international investment policy. This brief helps set the stage for such a discussion.

Option A: Minor updates to the current system

The easiest option for renegotiating the investment protection section of NAFTA is to stick with the broad contours of the current system, while perhaps making minor updates to reflect changes in the countries’ investment treaty practice in recent years. This would keep the main substantive protections for investors and the process of ISDS in place, while seeking for example to improve the transparency of investor-state arbitration processes and more precisely define governments’ rights and obligations in regulating investment.

This outcome could be achieved with little negotiation, since in practice all it requires is replacing NAFTA’s Chapter 11 with the recently negotiated investment chapter in the Trans-Pacific Partnership (TPP). All three NAFTA members participated in the TPP talks; Trump of course has since withdrawn the U.S., but there is no reason to believe this was out of disagreement with the specific wording of the invest-
ment chapter rather than with the agreement’s trade liberalization measures. If NAFTA members want to pursue this option, the text is already prepared for them—this would free up bureaucratic and political efforts to focus on other aspects of NAFTA where it may prove more difficult to reach agreement.

Another advantage of sticking with the current system is that it would reduce uncertainty and likely be welcomed by the business communities in all three countries. Whatever their other merits or detractions, the three alternative policy options would all constitute substantial changes to the investment protection regime. Such changes introduce uncertainty and adjustment costs, and the business community, which is reasonably happy with how ISDS works today, would likely rather stick with what they know.

The inherent conservatism of such an approach, however, is also its biggest drawback: It will do little to address many of the underlying challenges and stresses in the ISDS system. For though officials from the Obama administration attempted to sell the TPP investment chapter as a significant improvement to the ISDS system, a close read of the legal text shows the changes were mostly cosmetic.1

Indeed, the investment chapter of TPP appears to reflect a political calculus to respond to criticisms of ISDS while doing as little as possible to actually reform the system. For example, one of the reasons ISDS became so politically contentious in recent years is public outrage over two claims brought by Philip Morris, challenging tobacco plain packaging laws in Australia and Uruguay. While Philip Morris eventually lost both cases, the public anger over these cases lingered, and served as a rallying cry for broader complaints against the ISDS system. The solution to this politically charged issue in the TPP is to maintain the basic ISDS system, but with a special carve-out saying the ISDS rules do not apply to any investments in the tobacco industry. Logically this is not a tenable position: either the ISDS critics are correct that the system threatens environmental and health regulations, in which case this should be a worry for much more than just the tobacco sector, or the ISDS supporters are correct that the system doesn’t impinge on the right to regulate, in which case there should be no need for a tobacco carve-out. It is extremely difficult to craft an internally consistent explanation for why ISDS is not appropriate for tobacco but is appropriate for all other sectors of the economy.

In brief, if the NAFTA partners are looking for the easiest solution on investment protection, simply adopting the language from the TPP would be a reasonable approach, and would represent modest improvements over the current treaty. Yet this would be a missed opportunity to at least consider some more creative and disruptive reforms of the ISDS system, and would do little to address some of the more fundamental questions about ISDS that governments and civil society actors have raised in recent years. The following three options would entail significantly greater changes to investment protection policy.

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Option B: Abandon treaty-based legalized investment protections

Another straight forward—if radical—approach would be to simply eliminate legalized investment protections from NAFTA altogether. The new NAFTA would not include any legally binding obligations on host states for how to treat investors from partner countries. While the treaty might still lay out some general points on welcoming foreign investment and promoting the rule of law, these would be principles rather than legal obligations. Under this system, if foreign firms believed they had been mistreated by the host government they could lobby their home government to press their case diplomatically and/or rely on the domestic legal system to settle disputes. In other words, they would have the same recourses available to most other investors.

Underlying this approach is a deeper question: should investment treaties exist at all? There are two basic motivations for why states might grant legalized investment protections through treaties. First, countries seeking to attract foreign direct investment (FDI) may worry that firms are underinvesting due to fears of expropriation or other mistreatment; treaty-based protections could theoretically help assuage such fears and, thereby, boost FDI. Yet the empirical record on whether investment treaties do in fact lead to greater FDI flows is at best mixed. And in a careful study specifically on U.S. economic agreements—arguably the most relevant comparator in the NAFTA context—Peinhardt and Allee (2012) find no significant effect of treaties on FDI flows. Moreover, recent research shows that, if anything, developing countries tend to treat foreign investors better, not worse than domestic ones; the notion that countries are systematically discriminating against foreign investors does not seem to hold up, at least for the current period. A second motivation for signing investment treaties is to depoliticize investment dispute settlement, i.e., freeing diplomats from needing to get involved in disputes by allowing private investors direct access to legal remedies. Again, while in principle this might make sense, in practice American diplomats continue to intervene diplomatically in investment disputes involving U.S. investors.

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2 Firms could also include investor-state arbitration clauses in whatever specific contracts they enter into with the host government.

3 A leading international legal scholar, M. Sornarajah, cites this as the central question of international investment law; see Sornarajah (2016), “An International Investment Court: Panacea or Purgatory?” Columbia FDI Perspectives No. 180, August 15, 2016.


whether or not an investment treaty is in place. Given the complications, risks, and political headaches that have accompanied investment treaties, why not just get rid of legalized investment protections in NAFTA altogether?

Such an approach might find support from some strange political bedfellows. Many civil society organizations on the left have long opposed ISDS and actively campaigned against it for decades, believing ISDS places corporate interests above the government’s right to regulate. These NGOs and activists would likely be happy to see ISDS taken out of NAFTA. Left-leaning Democrats in Congress, most notably Senator Elizabeth Warren, have also publicly opposed ISDS; dropping investment protections from the new NAFTA could feasibly help win some congressional support from this group. At the same time, Trump and the economic nationalist wing of the Republican Party might also be happy to shelve investment provisions in NAFTA. After all, the general purpose of such provisions is to make it easier for companies to set up foreign production facilities, a practice Trump has repeatedly railed against both as a candidate and since assuming office. Why would Trump want to make it any more attractive for U.S. auto companies to locate their factories in Mexico?

Yet in all three NAFTA countries there would likely be staunch opposition to abandoning legalized investment protections from the business community, along with their political backers (such as most Republicans in Congress). Even though only a tiny fraction of foreign investors might ever use NAFTA’s ISDS to resolve a dispute, having the option to threaten an ISDS case may be of some value to firms. Moreover, during an era when many different countries are rethinking their investment policies, a decision by the NAFTA members to abandon ISDS would send a strong signal to the rest of the world, and could set a dangerous (from business’ point of view) precedent. If the U.S., Canada, and Mexico give up on ISDS in the renegotiated NAFTA, would other countries include ISDS in any treaties going forward?

Furthermore, both Canada and Mexico might worry about abandoning legal investment rules just as political risks in the U.S. seem to be rising. Trump has repeatedly singled out individual companies—both foreign and domestic—and threatened them with “huge tariffs” if they do not move production to the US. While it is unclear whether he would try to follow through on such threats, it is not unreasonable to assume foreign firms in the U.S. might value legal protections against arbitrary interventions more than they did prior to the election. Thus Mexico and Canada may want to preserve their rights to legalized investor-state dispute settlement, if only as a hedge against some of the more extreme policies Trump might pursue.

Option C: State-state dispute settlement

A third option for renegotiating the investment protection chapter of NAFTA is to keep many of the substantive rights for foreign investors in place, but significantly change the procedural processes for enforcing such rights. Specifically, this would mean getting rid of ISDS, and instead replacing it with a
state-state dispute settlement mechanism. If a private investor (or group of investors) believed a host state was in breach of its investment obligations in NAFTA, it would ask its home state to bring a case on its behalf; the home state could then decide whether it believed the case merited initiating a formal claim.

Switching to a state-state dispute settlement procedure would allow the renegotiated NAFTA to preserve substantive investment protections while doing away with at least some of the most politically contentious aspects of ISDS. Critics of investment treaties often argue that granting corporations the right to sue sovereign states in “secret courts” is fundamentally unjust; this would undercut that argument. A state-state mechanism could help rebalance public and private interests in the investment regime, ensuring governments—rather than corporate interests or the legal community of arbitrators—maintained control over the evolution of NAFTA’s investment law. And states would have the power to keep particularly controversial claims, such as Philip Morris’ challenge of tobacco regulations, from going forward.

While switching from investor-state to state-state dispute settlement in NAFTA would be a dramatic change, it would not be unprecedented. The U.S.-Australia free trade agreement (FTA), ratified in 2005, excludes ISDS, instead envisioning firms will pursue remedies first through the domestic legal system and allowing for state-state dispute settlement when this is unsuccessful. Brazil has recently adopted a new model bilateral investment treaty that prominently features state-state dispute settlement in place of ISDS. In fact, almost all modern investment treaties include the option of state-state dispute settlement mechanisms in addition to investor-state mechanisms, however the former are almost never used. But if the NAFTA parties wanted to reorient investment protection around state-state claims, there would be plenty of treaty language to draw on.

A less extreme variant of this option would preserve the basic structure of ISDS, but would include a home state filter on investor claims, allowing governments to block particularly controversial (or obviously frivolous) ISDS cases. Once an investor had initiated a claim under NAFTA, that investor’s home government would have the option to prevent the claim proceeding to arbitration. While such a right might rarely be invoked, it would be one means for governments to assert greater control over the investment regime. The recently negotiated China-Australia FTA includes a similar political filter, where if both the Chinese and Australian governments agree a potential ISDS claim is about a non-discriminatory regulatory issue, the claim will not proceed.

As with Option B above, the pushback to a state-state regime is most likely to come from the business community, which dislikes the idea of being reliant on governments to enforce investment rights. Yet, if forced to choose between no investment protections at all—or even no agreement on NAFTA—and a state-state mechanism, business leaders would very likely get behind the latter, suggesting this could be a compromise solution.
Option D: The multilateral investment court

A fourth option for investment protection in NAFTA comes not from any of the NAFTA parties themselves, but rather from the European Union. Two years ago, in the midst of negotiations with the U.S. over the proposed Transatlantic Trade and Investment Partnership (TTIP), there were large protests in many European countries against ISDS. Following a lengthy public consultation, European officials realized that including traditional ISDS in TTIP would make it extremely difficult to get the agreement approved by national parliaments, and thus they decided to look for an alternative approach.

The solution they came up with is a multilateral investment court. Investors would still have the right to file claims directly against sovereigns, but instead of ad hoc tribunals decided by private arbitrators, under the proposed investment court investment disputes would be decided by a set of permanent judges appointed by member governments. The court would include an appeals mechanism, so that controversial or contentious judgments could be reviewed, and strict conflict-of-interest rules for judges, addressing the complaint of ISDS critics that arbitrators often serve as lawyers in one case and as arbitrators the next.

The Obama administration never formally responded to Europe’s proposal before TTIP talks were indefinitely put on hold. Yet as it happens the EU was also finalizing a trade agreement with Canada at the same time, and a preliminary version of the investment court system made it into that deal, known as CETA, the Comprehensive Economic and Trade Agreement. Since then, Canada (along with the EU) have publicly advocated for this court and are actively seeking to recruit new members. In principle, it would be logical for Canada to seek to discuss the multilateral investment court in the context of NAFTA negotiations. Meanwhile, the EU and Mexico have recently begun negotiations to update the existing EU-Mexico FTA, and it is possible the multilateral investment court will make its way into this deal too.

Is something like the multilateral investment court a viable option for a renegotiated NAFTA? Given that Canada has already signed on, it represents the most dramatic ISDS reform that has been formally endorsed by any of the NAFTA parties. At the same time, in light of Trump’s clear distaste for multilateralism and shielding of American sovereignty, it is unlikely his administration would join a new international court. Moreover, the court is still untested and would again face pushback from the business community that prefers traditional ISDS. Nor would it necessarily satisfy the ISDS critics, many of whom continue to oppose any system that grants foreign corporations special rights to sue sovereign states. Of course, disappointing both sides of this debate may be evidence that the investment court strikes the right balance. But it is not clear there is a viable coalition that would provide sufficient political support for an investment court approach in NAFTA.

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Conclusion

This brief has presented the contours of four broad options for investment protection in a renegotiated NAFTA, of which three would represent considerable departure from current practices in American investment treaty policy. Of course, within each of these options there are many different possibilities and variations. Moreover, the impact of any new investment protections will depend crucially on their details; as in any legal text, the specific wording of clauses in trade and investment treaties is critical and determines their ultimate effects.

Each of these four options has advantages and drawbacks, and I am not interested here in specifically advocating for one approach above the others. Rather, the purpose of this brief is to foster more informed debate on the relative merits of these different approaches, and in general to advocate for more ambitious and creative thinking on investment protection policy, particularly in the U.S.

In recent years, many governments, including in Brazil, India, Australia, South Africa, Indonesia, and the EU, have significantly rethought their approach to investment protection, leading to many policy innovations. In the U.S., meanwhile, the scope of the debate on investment policy reform has remained quite narrow, with proposed reforms focused on tweaking the margins of the model treaty, rather than more fundamentally reconsidering investment policy.

NAFTA’s renegotiation, however, presents an opportunity to accelerate public debate on the future of investment protection, rethinking standard models and considering bold policy changes. We should not let this opportunity go to waste.

Ultimately, whatever path the NAFTA members choose for investment protection, it could have significant effects on the evolution of the broader international investment regime. A renegotiated NAFTA will likely serve as an important precedent for future trade and investment treaties. Indeed, the first NAFTA had an outsized effect on the investment treaty practice of several European, Asian, and American countries. Earlier investment treaties were typically short, imprecise texts leaving lots of room for legal interpretation; NAFTA brought greater precision and clarity to the legal protections afforded foreign investors. NAFTA similarly helped shape norms around issues such as transparency in arbitration cases and the right to submit amicus curiae briefs. For these reasons, NAFTA has been referred to as the first of the “second generation” of investment treaties, supplanting the earlier investment models of Western European powers. All stakeholders fighting over the future of the international investment regime should consider the possibility that a renegotiated investment chapter in NAFTA could have similarly wide-ranging effects, and should push for a comprehensive debate in the soon-to-launch negotiations.

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