

Understanding ISDS: A System Under Scrutiny

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Intro

A cross-border investment continues to rise around the world, conflicts between international investors and host governments have become increasingly common. The established system for resolving these disputes is known as **Investor-State Dispute Settlement (ISDS)** and is often incorporated in bilateral investment treaties and preferential trade agreements. ISDS relies on a lengthy and costly legal process that is facing mounting criticism from governments, stakeholders, and the public, sparking active discussions on how to reform or replace this system.

In this article, Washington CORE explores the evolving ISDS landscape, the challenges it faces, and the potential paths forward, drawing on recent insights from Andrew Lugg, Assistant Professor of Political Science at the University of Nevada, Las Vegas.

Growing Headwinds for ISDS

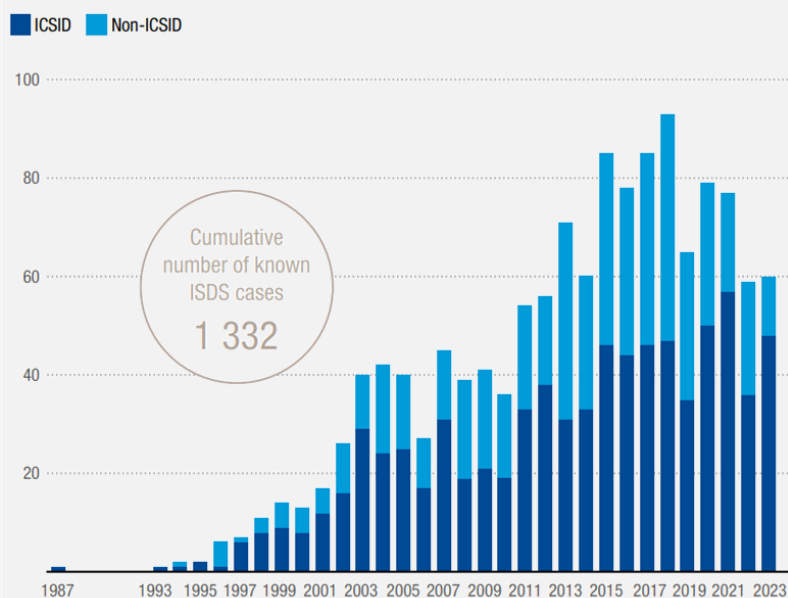
The primary promise of ISDS was that it would provide a de-politicized legal system that protected international investors from discriminatory treatment. This, it was hoped, would facilitate cross-border Foreign Direct Investment (FDI) flows. However, over time, ISDS has grown unpopular among governments around the world, with criticism coming from countries in the Global South and the Global North. While early opposition stemmed from developing nations concerned about the disproportionate litigation costs and frequency of claims against their governments, skepticism is now also widespread across developed countries.

According to Professor Lugg, a key reason behind this shift is partisan opposition emerging from across the political spectrum. In developed regions and countries like Europe, North America, Australia, and New Zealand, opposition has traditionally come from left-leaning politicians and activists who view ISDS as favoring multinational corporations at the expense of host country community interests.

In the United States specifically, opposition has also risen from right-leaning politicians who are increasingly critical of international organizations and courts, which they view as undermining national sovereignty. Additionally, they express concerns that ISDS might incentivize U.S. investors to prioritize overseas investments over domestic opportunities, potentially shifting jobs and production out of the country.

The global number of ISDS cases surpassed 1,300 at the end of 2023

(Annual number of known treaty-based cases)



Source: UNCTAD, ISDS Navigator database, accessed 25 September 2024.

Note: Information has been compiled from public sources, including specialized reporting services. UNCTAD statistics do not cover investor-State cases that are based exclusively on investment contracts (State contracts) or national investment laws, or cases in which a party has signaled its intention to submit a claim to ISDS but has not commenced the arbitration. Annual and cumulative case numbers are continually adjusted as a result of verification processes and may not match exactly case numbers reported in previous years.

Abbreviations: ICSID = International Centre for Settlement of Investment Disputes, ISDS = investor-State dispute settlement.

https://unctad.org/system/files/official-document/diaepcbinf2024d5_en.pdf

This tension has been evident in recent U.S. trade policy decisions. In the negotiation of the 2019 U.S.-Mexico-Canada Agreement (USMCA) by the first Trump administration, access to ISDS was eliminated for cross-border investment between the U.S. and Canada and significantly reduced between the U.S. and Mexico. This policy reflected Trump's U.S. First economic approach, aimed at encouraging domestic investment in the U.S. economy. This will likely continue into the second Trump term.

This combination of critiques from different economic and political views, Lugg notes, has made ISDS an easy target for criticism and politicization. "Nobody is seemingly willing to stand up for it," he says, adding that advocates for the ISDS system, including some government officials and members of the business community, often find their voices drowned out by the sheer volume and variety of opposition.

FDI and ISDS : The Data Deficit

Lugg said academic studies to date have yielded mixed evidence on whether the ISDS system fulfills its intended purpose to facilitate FDI flows. Drawing conclusions is complicated by the lack of data about how the ISDS process plays out.

Lugg's research aims to address some of the latter gaps by collecting data on the escalation process leading to ISDS cases. "We don't have reliable data on what triggers firms to escalate to ISDS or why some disputes result in arbitration while others are resolved through alternative means," he explains. By collecting and analyzing new data, his work seeks to provide a clearer picture of ISDS's true impact on the overall credibility of international investment agreements.

The Complex Nature of Global Trade and Investment

The evolving dynamics of global trade and investment further complicate the operation of the ISDS framework. Traditionally, countries like China and Korea were primarily capital importers and thus potential respondents to ISDS claims from foreign investors. However, as they have transitioned to become major capital exporters, their roles within the system have shifted, and now their companies also have cause to make ISDS claims against other governments. Lugg suggests that competing agendas among countries with varying economic priorities create significant hurdles to reaching international agreements on how ISDS should evolve. For example, ISDS was notably excluded from the recently negotiated Regional Comprehensive Economic Partnership

Exploring Alternatives : The Role of Dispute Prevention

The mounting criticism of ISDS has led to increased interest in alternative mechanisms for resolving disputes. Research efforts are being led by international organizations such as Asia-Pacific Economic Cooperation to explore dispute prevention and mitigation models as promising solutions. These models emphasize mediation and dialogue, offering less adversarial pathways to dispute resolution. Successful implementations of this approach include Korea's Office of the Foreign Investment Ombudsman and Japan's Office of Trade and Investment Ombudsman.

Key Challenges and Opportunities for Reform

Reforming ISDS presents many challenges. The process must seek to balance the interests of investors and host governments while addressing criticisms about cost, fairness, and sovereignty. Procedural reforms and arbitration processes could mitigate some efficiency and cost concerns, while improving the fairness and consistency of awards could address both investor and state grievances.

The Broader Implications of ISDS Reform

At its core, ISDS reflects the complexities of globalization. ISDS's potential to facilitate capital flow and economic development must be weighed against its shortcomings and the evolving realities of global trade and investment. A well-functioning ISDS system should enhance global wealth by enabling the direction of capital to where it is most needed. However, the lack of consensus on what a 'better' system looks like remains a significant obstacle.

The ongoing debates and research efforts, such as those led by Professor Lugg, offer hope for a more equitable and effective system. Addressing the legitimacy crisis and embracing innovative solutions like dispute prevention systems could be significant steps forward. As the global trade and investment landscape continues to evolve, the lessons learned from ISDS's shortcomings will be crucial in shaping the next generation of investment dispute resolution mechanisms. The stakes are high, but so too is the potential for creating a system that works for investors and states alike.

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His research has been published or is forthcoming in a range of outlets, including *International Studies Quarterly*, *The Review of International Organizations*, *The Journal of Conflict Resolution*, *Political Research Quarterly*, Cambridge University Press, *Research and Politics*, *The Journal of International Economic Law*, and *Global Policy*. He has also co-authored reports for the World Bank, USAID, and the European Parliament.

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