Disputes in International Investment and Trade

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- the remedial period
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Trade agreements typically employ tariff retaliation as the remedy for violation of the agreement. The award of cash damages is the norm in investment disputes.

And trade agreements typically provide for only prospective remedies. The damages awarded in investment disputes routinely cover past as well as future harms.
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- We develop parallel models of trade agreements and investment agreements and employ them to study these differences
  - we argue that the differences can be understood as arising from the fundamentally different problems that trade and investment agreements
Standing

Who should have standing to file a court case and invoke the DSB?

- only govs (SSDS)?
- or also private agents (ESDS/ISDS)?

To focus on standing, we make two simplifying assumptions which we later relax

- nature of the remedy: a court order amounts to “cease and desist,” and there are no damage payments as part of the court’s ruling
- the remedial period: compliance is instantaneous, and there is no pre-compliance harm for which additional remedies might be desirable
Trade Agreements: Standing

- Starting point: trade agreements are primarily concerned with market access commitments
- Our model tracks closely basic structure of Maggi and Staiger (2011)
  - For $s \in \sigma^{FT}$, $FT$ is first best ($\Gamma(s) \equiv \gamma_G(s) + \gamma^*_G(s) \leq 0$)
  - For $s \in \sigma^P$, $P$ is first best ($\Gamma(s) > 0$)
- In states of world where obligation of importer gov under the agreement is vague (e.g., $P$ allowed to address “serious injury”)  
  - importer gov chooses $\tau \in \{FT, P\}$
  - foreign complainant chooses whether to file a complaint with DSB to dispute a choice of $P$, DSB will rule based on noisy signal of $\Gamma(s)$
- Equilibrium disputes reflect opportunistic behavior on the part of importer gov or foreign complainant to exploit incompleteness of contract and inaccuracy of DSB rulings
Let $f \in \{G^*, E^*\}$ denote foreign complainant with standing

Foreign complainant files iff $\tau = P$ and

$$\Pr(\text{DSB ruling is } FT \mid s) \times |\gamma_f^*(s)| > c_f^*(s)$$

(1)

Importer gov chooses $\tau = P$ if either (1) fails or if (1) holds and

$$\Pr(\text{DSB ruling is } P \mid s) \times \gamma_G(s) > c(s)$$

(2)
Trade Agreements: Standing

Assume dispute costs small relative to dispute stakes

Lemma 1.

1. In states $s \in \sigma^{FT}$: If DSB quality is high we have $\tau = FT$ and no dispute; if DSB quality is intermediate we have $\tau = P$ and a dispute; if DSB quality is low we have $\tau = P$ and no dispute.

2. In states $s \in \sigma^P$: If DSB quality is high we have $\tau = P$ and no dispute; if DSB quality is intermediate we have $\tau = P$ and a dispute; if DSB quality is low we have $\tau = FT$ and no dispute.

⇒ Three sources of inefficiencies relative to the first best

- one associated with the probability of DSB error
- one associated with the cost of a dispute
- one arising from distorted choices made “in the shadow of the court”
Trade Agreements: SSDS vs ESDS

Assume

\[ c_{G*} = c_{E*} \equiv c^* \]  \hspace{1cm} (Assumption 1)

\[ |\gamma_{G*}^*(s)| < |\gamma_{E*}^*(s)| \]  \hspace{1cm} (Assumption 2)

⇒ Adopting ESDS rather than SSDS amounts to the foreign gov delegating filing decisions to a more aggressive filer than itself

- filing decision under ESDS takes account of private benefits of litigation to the foreign exporters but ignores costs to other foreign actors

Define \( L(ESDS) \) as loss relative to first best under ESDS, \( L(SSDS) \) as loss relative to first best under SSDS
Let $q_k(s) \in (0, 1/2)$ be probability that court issues “wrong” ruling.

Define $\Delta_{E^*, G^*} \equiv L(\text{ESDS}) - L(\text{SSDS})$

\[
\Delta_{E^*, G^*} = \sum_{s \in \Omega^P_S} p(s) \{ q_k(s) |\Gamma(s)| + c(s) + c^*(s) \} \\
+ \sum_{s \in \Omega^{FT}_S} p(s) \{ -[1 - q_k(s)] |\Gamma(s)| + c(s) + c^*(s) \}.
\]

The first term is positive
- reflecting $s \in \Omega^P_S$ where the efficient choice $\tau = P$ was unchallenged under SSDS but leads to a court filing under ESDS

The second term is also positive
- reflecting $s \in \Omega^{FT}_S$ where the importer gov chooses inefficient $\tau = P$ with impunity under the SSDS but a filing occurs under ESDS
- the exporter gov does not see a filing as worth the dispute cost while the importer gov never benefits from a filing, hence value of the agreement to the two govs is reduced by these filings
Proposition

_Governments, but not their exporters, should have standing to bring disputes in an optimally designed trade agreement. That is, an optimally designed trade agreement should include SSDS, but not ESDS._

- Intuitively, under SSDS the govs themselves would adopt behavior which leads to too much litigation, owing to the negative external effects that are not internalized in their decision to litigate.
- and so granting standing to private actors that would add to this (overly-) litigious behavior will lower the joint surplus obtained by the govs under the agreement.
BITs: Standing

- Starting point: BITs are primarily concerned with solving a gov commitment problem
  - BIT used by host gov to make policy commitments to foreign investors

- Two changes to the previous model

- First, the host (formerly home) gov investment policy $i$ can be either $T$ for “Taking” or $FT$ for “Free Trade”
  - $T$ a stand-in for a wide variety of investment policies the could amount to a “taking” broadly defined

- Example of vague obligation in a BIT
  - $T$ allowed “for a public purpose, provided that adequate and effective compensation is promptly paid”

- And second, we introduce an ex-ante foreign investment stage
BITs: Standing

- Host country small in world capital markets, faces infinitely elastic ex-ante supply of foreign capital at world rate of return $r^*$

- investment made by a single investor facing elastic demand for output; once made, the investment is sunk

- investment level $I^*$ results in output level $Q = I^*$, sold at market clearing price $\tilde{P}(I^*)$ yielding operating profits $PS(I^*) = \tilde{P}(I^*)I^*$ and consumer surplus $CS(I^*) = \int_{\tilde{P}(I^*)}^{\infty} D(P) dP$

- production/consumption of this output may generate a negative (local) externality $e(I^*, s) = e(s)I^*$, with either $e(s) = 0$ or $e(s) > \tilde{P}(0)$

- $e(s) = 0 \Rightarrow$ ex-post social value of investment is $PS(I^*) + CS(I^*) > 0$: $FT$ is efficient, $s \in \sigma^{FT}$

- $e(s) > \tilde{P}(0)$ and ex-post social value of investment is $PS(I^*) + CS(I^*) - e(I^*, s) < 0$: $T$ is efficient, $s \in \sigma^T$
Foreign investor earns return $\tilde{P}(I^*)$ per unit of FDI under $FT$ and earns 0 under $T$

Conditional on level of FDI $I^*$, host gov receives ex-post payoff of

- $s \in \sigma^T$: $\omega(I^*, T, s) = 0; \omega(I^*, FT, s) = CS(I^*) - e(I^*, s) < 0$
- $s \in \sigma^{FT}$: $\omega(I^*, FT, s) = CS(I^*); \omega(I^*, T, s) = CS(I^*) + \kappa PS(I^*)$

where $\kappa \in (0, 1)$ reflects degree of ex-post inefficiency associated with the host gov’s taking in $\sigma^{FT}$

Joint ex-post gain from a taking

- $s \in \sigma^T$: $\Gamma(I^*, s) = -[PS(I^*) + CS(I^*) - e(I^*, s)] > 0$
- $s \in \sigma^{FT}$: $\Gamma(I^*, s) = -(1 - \kappa) PS(I^*) < 0$

$\Rightarrow$ ex-post inefficiency from taking in $\sigma^{FT}$ goes away as $\kappa \to 1$, but ex-ante inefficiency (level of $I^*$) remains
BITs: Standing

- First best
  - if investor expects first-best treatment, $l^*$ satisfies $p^{FT} \tilde{P}(l_{FB}^*) = r^*$
  - if host gov can commit to first-best policies $l_{FB}$, ex-ante expected payoff for host gov is $E_s[\omega(l_{FB}^*, l_{FB}, s)] = p^{FT} CS(l_{FB}^*)$

- Limited commitment (with probability $\bar{p}$)
  - if investor expects limited-commitment treatment, $l^*$ satisfies $\bar{p} p^{FT} \tilde{P}(l_C^*) = r^*$
  - if host gov maintains limited commitment policies $l_C$, its expected payoff is $E_s[\omega(l_C^*, l_C, s)] = p^{FT} [CS(l_C^*) + (1 - \bar{p}) \kappa PS(l_C^*)]$

- Host gov benefits from commitment, foreign investor expects $r^*$ either way
  - $\Rightarrow$ a gov-to-foreign-investor commitment problem
  - can a BIT serve as a useful commitment device for host gov?
BITs: Standing

Prior question: Can an up-front investment incentive program solve the host gov’s commitment problem?

Lemma 2. An up-front investment incentive program can help solve the host gov’s commitment problem with regard to foreign investors, but it cannot by itself achieve the first best as long as $(1 - \bar{p})(1 - \kappa) > 0$.

Can a BIT improve upon stand-alone investment incentives?

Once $I^*$ has been sunk, the BIT works just like the trade agreement.

Proposition

The introduction of a BIT can lead to efficiency gains and benefit the host government relative to stand-alone up-front investment incentives for foreign investors if and only if the quality of the court is sufficiently high and the quality of domestic institutions is sufficiently weak.
BITs: SSDS vs ISDS

- Assume
  \[ c_{G*}^* = c_{I*}^* \equiv c^* \] (Assumption 1’)
  implying \( c_{G*}^*(l^*, s) = c_{I*}^*(l^*, s) \equiv c^*(l^*, s) \) for all \( s \)

- Assume
  \[ \gamma_{G*}^* < \gamma_{I*}^* = 1 \] (Assumption 2’)
  implying \( |\gamma_{G*}^*(l^*)| < |\gamma_{I*}^*(l^*)| \)

⇒ Any difference between a BIT with SSDS vs ISDS must reflect differences across the complainants’ payoffs from winning in court
  - the foreign gov’s gain from winning in court is less than the producer surplus that foreign investors would lose in a taking
  - gov incurs political/diplomatic costs that investors do not internalize
BITs: SSDS vs ISDS

- We seek sufficient conditions for
  \[ E_s[\omega_{I^*}(\bar{I}_{I^*}, s)] > E_s[\omega_{G^*}(\bar{I}_{G^*}, s)] \]
  and hence for ISDS to be part of an optimal BIT

- Holding investment at the optimal level under a BIT with SSDS (\(\bar{I}_{G^*}\))
  calculate
  \[ E_s[\omega_{I^*}(\bar{I}_{G^*}, s)] - E_s[\omega_{G^*}(\bar{I}_{G^*}, s)] = \Delta_{BIT} \]

- Then \(\Delta_{BIT} > 0 \Rightarrow E_s[\omega_{I^*}(\bar{I}_{I^*}, s)] > E_s[\omega_{G^*}(\bar{I}_{G^*}, s)]\)
  given that \(E_s[\omega_{I^*}(\bar{I}_{I^*}, s)] \geq E_s[\omega_{I^*}(\bar{I}_{G^*}, s)]\)
BITs: SSDS vs ISDS

Let $C(\bar{I}^*_{G}, s) \equiv c^*(\bar{I}^*_{G}, s) + c(\bar{I}^*_{G}, s)$. Then $\Delta_{BIT} =$

$$(1 - \bar{p}) \sum_{s \in \bar{\Omega}^{FT}} p(s) \{(1 - qk(s)) (1 - \kappa) PS(\bar{I}^*_{G}) - C(\bar{I}^*_{G}, s)\} - \sum_{s \in \bar{\Omega}^{T}} p(s) \{qk(s) [e(\bar{I}^*_{G}, s) - CS(\bar{I}^*_{G}) - PS(\bar{I}^*_{G})] + C(\bar{I}^*_{G}, s)\}$$

The sign of the first line is ambiguous, reflecting the welfare impacts of additional litigation in $s \in \bar{\Omega}^{FT}$

- $(1 - \kappa)$ of producer surplus is saved by correct ruling, but at the expense of host and foreign litigation costs
- becomes positive as $\kappa \rightarrow 0$ and as host litigation cost $c \rightarrow 0$, and large as $\bar{p} \rightarrow 0$

The second line is negative, reflecting welfare losses from the additional litigation in $s \in \bar{\Omega}^{T}$, but goes to 0 as $p^{T} \rightarrow 0$
Proposition

Whether investors, in addition to their governments, should have standing to bring disputes in an optimally designed BIT depends on a number of subtle tradeoffs. But if the host government is highly inefficient in orchestrating takings for $s \in \sigma^{FT}$ and bears little cost of defending itself in court, and if domestic institutions are sufficiently weak and expropriation is socially efficient only in unusual circumstances, then it is optimal to give investors standing to bring disputes in a BIT. That is, if $\kappa$, $c$, $\bar{p}$ and $p^T$ are sufficiently low, an optimally designed BIT should include both an SSDS and an ISDS.
Intuition

- if inefficient takings create large ex-post inefficiencies, then litigation to avert them can bring substantial gains
- if litigation costs for defendants are lower, the costs of increased litigation under ISDS relative to SSDS are less burdensome
- if domestic institutions are weak, they cannot be counted on to protect investors
- and if “expropriation” is efficient only infrequently, the probability of inefficient litigation over desirable takings is diminished
BITs: SSDS vs ISDS

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  • and if “expropriation” is efficient only infrequently, the probability of inefficient litigation over desirable takings is diminished

• Note: while these conditions are plausibly met in some circumstances, the case for ISDS provisions in BITs is far from absolute

  • perhaps plausible for North-South, not likely for North-North
Nature of the Remedy

- We compare two institutional setups: one in which the court allows reciprocal retaliation, another in which the court awards cash damages.
  - key assumption: cash value of harm from $T$ suffered by foreign investor is easy to quantify compared to harm from $P$ suffered by foreign gov.

Proposition

Allowing for retaliation instead of cash damages in a trade agreement is optimal if (1) the court’s ability to assess cash damages is sufficiently bad relative to its ability to assess the state of the world, and (2) free trade is sufficiently likely to be the efficient policy choice.

Proposition

Allowing for cash damages instead of retaliation in a BIT is optimal if (1) the court’s ability to assess cash damages is sufficiently good relative to its ability to assess the state of the world, and (2) there is a non-trivial probability that a taking is the efficient policy.
What is the optimal “remedial period”? 

- is it optimal to include retrospective damages in the remedy (damages for harm suffered before the case is finally adjudicated)?
- or just prospective damages (damages that would arise after adjudication if the ruling is not obeyed)?

We let $\delta \in [0, 1]$ parameterize the fraction of harm from the policy action at issue that occurs prior to the court ruling:

- all the costs of delay in adjudication including lost profits on export sales, losses experienced due to impairment of sunk investments
- if $\delta = 0$, there is no pre-ruling harm, as in our earlier model; if $\delta = 1$, the harm has all occurred and is a bygone by the time of the ruling
- we think of lower values of $\delta$ as reasonable for trade disputes
- we think of higher values of $\delta$ as reasonable for investment disputes
The Remedial Period

- Building on our earlier results
  - we assume that the trade agreement has adopted SSDS while the BIT has adopted ISDS
  - we use $\beta \in (0, 1]$ to denote the fraction of each dollar given up by the home/host gov that reaches the foreign claimant as damage payments
  - we assume that the retrospective remedy takes the form of retaliation for the trade agreement ($\beta$ small) and cash damages for the BIT ($\beta$ large)

- To keep the comparison clean
  - we continue to assume that the prospective remedy takes the form of a cease and desist order for both the trade agreement and the BIT
  - when $\delta = 0$ and there is no pre-ruling harm, the model collapses to our earlier model
Proposition

A prospective remedy is optimal for a trade agreement provided that the degree of litigation delay is sufficiently short (\(\delta\) small), transfers in the context of a trade dispute are sufficiently costly (\(\beta\) small) and the quality of the court is sufficiently high (\(q\) low).

Intuition

- for any fixed court quality \(q\), the joint surplus under a trade agreement with retrospective damages approaches that associated with \(FT\) in all states as \(\beta \rightarrow 0\) and the cost of transfers becomes prohibitive.
- and if \(q\) is fixed at a sufficiently low level, then as \(\delta \rightarrow 0\) so that litigation delay is sufficiently short, the joint surplus under a trade agreement with prospective damages approaches the first best level.
- which exceeds the joint surplus associated with \(FT\) in all states and therefore beats a system with costly retrospective damages.
Proposition

A retrospective remedy is optimal for a BIT provided that the degree of litigation delay is sufficiently long (\(\delta\) large), transfers in the context of a BIT are sufficiently efficient (\(\beta\) large) and the quality of the court is sufficiently high (\(q\) low).

Intuition

- for any fixed court quality \(q\), as \(\delta \to \bar{\delta}\), the expected payoff to the host gov under a BIT with prospective damages approaches that associated with a program of up-front investment incentives to foreign investors
- and provided that \(\beta\) is not too small, if \(q\) is fixed at a sufficiently low level and for any \(\delta \in [0, 1]\), the expected payoff to the host gov under a BIT with retrospective damages approaches the first best level
- which exceeds the expected payoff under a program of up-front investment incentives and therefore beats prospective damages
The Remedial Period

- Summarizing: If court quality is sufficiently high ($q$ is sufficiently low), prospective damages are employed in trade agreements such as the WTO while retrospective damages are employed in BITs because

  - the degree of pre-ruling harm is typically more severe in the context of investment disputes as compared to trade disputes ($\delta$ is high for investment disputes but low for trade disputes) so that prospective damages become a poor option for effective investment agreements

  - and the available means of making international transfers are much less efficient in the context of trade disputes as compared to investment disputes ($\beta$ is low for trade disputes but high for investment disputes)

  - making retrospective damages prohibitively expensive in the context of trade agreements and therefore unattractive in that context

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International investment and trade agreements employ dispute settlement procedures that differ markedly along three key dimensions: standing, the nature of the remedy, the remedial period.

Our results suggest that there are plausible conditions under which these broad differences can be viewed as an optimal response to the different environments within which these agreements operate.

At the same time, our results indicate that some of the most controversial features of these procedures, such as providing standing for investors to bring claims against foreign governments in investment disputes, are far from universally optimal under all circumstances.

This suggests that such features deserve close scrutiny before drawing the conclusion that they are warranted in the circumstances where they are present.