The politics of reforming Investor-to-State Dispute Settlement
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Non-state actors and institutional legacies as determinants of dispute settlement design

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Abstract: International dispute settlement mechanisms have become a prevalent and causally significant feature of global governance. The causal effects of international dispute settlement mechanisms on international politics and international political economy depend to a large extent on their institutional design and namely judicial autonomy. Our understanding of why states favour different dispute settlement designs and degrees of judicial autonomy remains incomplete though. Existing research suggests that evolving interstate power asymmetries or collective action problems shape state preferences on dispute settlement designs over time. Upon closer examination, these theories, however, fail to explain evolving state preferences with regard to important international dispute settlement mechanisms such as investor-to-state dispute settlement (ISDS). This article develops a complementary explanation focusing on non-state actors and institutional legacies. A growing number of international dispute settlement mechanisms indeed resolves transnational disputes between state and non-state actors rather than interstate disputes. State exposure to non-state actor claims and related costs – rather than evolving interstate relations – should shape state preferences on dispute settlement designs and judicial autonomy. Institutional legacies moreover determine the most efficient reform strategies available to states and therefore serve as important intervening variable shaping state preferences and reform efforts. The article empirically tests the argument at the example of the USA and EU's recent efforts to reform ISDS.

1. Introduction

The global investment regime has become subject to intense reform debates and efforts in recent years. The European Union (EU), its member states and the USA push for far-reaching reforms of the design of conventional investor-to-state dispute settlement (ISDS) mechanisms as enshrined in thousands of bilateral investment treaties (BITs) and modern comprehensive free trade agreements. European and US policy-makers emphasise in particular the need to enhance the accountability and legitimacy of ISDS proceedings and to ring-fence states' right to regulate. European and US reform efforts are noteworthy in two regards. First, European and US policy-makers invented and were the main force behind the diffusion of international agreements with conventional ISDS mechanisms since the 1950s. Hence, European and US calls to reform ISDS and the global investment regime mark a fundamental shift in state preferences. Second, European and US policy-makers, nonetheless, pursue markedly different reform strategies and design outcomes. While US policy-makers pursue incremental reforms of ISDS by amending existing and model investment agreements, European policy-makers advocate wholesale reforms inter alia through the creation of a permanent UN-based multilateral investment court to replace conventional ad hoc arbitration.

How can one explain the shift in European and US preferences and strategies to reform the design of ISDS in recent years? A sizeable body of research theorises the causalities shaping state preferences on dispute settlement designs yet fails to offer compelling explanations. Scholars standing in the tradition of neo-liberal regime theory (Keohane, 1984; Nye, 1988), rational choice institutionalism (Koremenos, 2016; Pelc and Urpelainen, 2015; Snidal, 1985) and principal agent theory (Alter, 2014, 2008; Hawkins et al., 2006; Majone, 2001) stipulate that states design dispute settlement mechanisms with the intent to resolve interstate collective action problems. Variation in state preferences and dispute settlement designs should thus echo variation in the collective action problem at hand. No evidence, however, suggests that European and US policy-makers have come to re-evaluate the fundamental functional purpose of international investment agreements with ISDS provisions as a tool for states to credibly commit to protecting property rights of foreign investors. The so-called 'rational design' school thus fails to account for the shift in EU and US preferences as well as diverging reform strategies. Scholars standing in the tradition of neo-realism (Drezner, 2007; Nye, 1988; Waltz, 1979), on the other hand, suggests that international institutions and dispute settlement mechanisms reflect underlying power asymmetries between states. States seek to consolidate and cement their power positions vis-à-vis other states in the international system through dispute settlement mechanisms with powerful states being able to promote their preferred designs and weaker states getting coerced into accepting them (Allee and Peinhardt, 2010; McCall Smith, 2000; Simmons, 2014). Variation in state preferences on dispute settlement designs should thus echo evolving interstate power asymmetries. European and US economic power – as measured through their share in global GDP and investment flows – has indeed diminished in recent years. The economic decline of the EU and US, however, has not shifted power asymmetries vis-à-vis recent negotiating partners such as Japan or Canada. The economic power of these economies has similarly diminished keeping power asymmetries stable. What is more, power-based theories struggle to explain the EU and US' diverging reform strategies as both economies saw similar economic declines.

In this article, I advance an alternative explanation to account for shifting EU and US preferences and reform strategies for ISDS building on the *new interdependence approach* (Farrell and Newman, 2016, 2014). My intention is not to knock down existing research on dispute settlement designs but to complement and sharpen our understanding. For one, existing research misconceives the nature of many modern international dispute settlement mechanisms as institutions to govern and resolve interstate disputes. In reality, international dispute settlement mechanisms increasingly grant legal standing and resolve transnational disputes between states and non-state actors. Models focusing on interstate relations are unlikely to explain state preferences on dispute settlement designs governing transnational disputes. Existing research, moreover, ignores that states nowadays rarely design dispute settlement mechanisms from scratch but reform existing ones. Static models to account for state preferences on institutional inception are unlikely to capture dynamics of institutional change over time. In the light of these theoretical gaps, I advance a twofold argument. First, states conduct a cost-benefit analysis to form preferences on dispute settlement designs (dependent variable). They weigh potential economic and political benefits – such as increased trade and investment flows and economic growth – against their exposure to litigation and related political and financial costs to determine a utility-enhancing dispute settlement design. Dispute settlement design is seen as a tool to manage in particular state exposure to litigation risks (independent variable) and thus the cost side of states' cost-benefit analysis. Dispute settlement design enables states to exert more or less control over the access and decision-making of dispute settlement mechanisms. This theoretical argument implies that EU and US preferences shifted in response to a surge in ISDS claims against them, which altered their cost-benefit ratio and triggered their interest in limiting state exposure to claims. Second, states' evolving cost-benefit ratios are, however, insufficient to fully account for evolving state preferences and indeed strategies to implement them. I assume that institutional legacies (intervening variable) determine cost-effective strategies to reform dispute settlement mechanisms and thus targeted design outcomes (Mahoney and Thelen, 2010; Streeck and Thelen, 2005). States' decision to pursue small-scale incremental or comprehensive wholesale reforms should depend on the concentration of litigation risks within states' treaty networks providing for relevant dispute settlement mechanisms. If states face high litigation risks only under a small number of treaties, they should prefer to amend these treaties as efficient strategy. If states face high litigation risks under a high number of treaties, however, states should opt for more encompassing reforms as efficient strategy. This theoretical argument implies that the US and the EU pursue different reform strategies and outcomes due to the diverging concentration of litigation risks within their respective treaty networks.

The article is structured as following. The next section defines the dependent variable of this article – namely state preferences on dispute settlement designs. The following section then discusses in more detail existing theories to account for variation in state preferences on dispute settlement design. These theories are state-centric and tie in with the dominant *open economy politics* paradigm of International Political Economy research (Lake, 2009). The fourth section develops in detail my complementary explanation focusing on non-state actor litigation and institutional legacies in the formation of state preferences, reform strategies and dispute settlement design outcomes. My explanation builds on the so-called *new interdependence approach* (Farrell and Newman, 2016, 2014), which stipulates that classic interstate relations play a lesser role in world politics in the wake of globalisation than often assumed. I then outline my methodological choices and assumptions and produce evidence to test different theoretical explanation. The last section concludes and discusses broader implications of this research.

2. Defining the spectrum – Variation in state preferences on dispute settlement design

I model state preferences on dispute settlement designs as my dependent variable. Dispute settlement mechanisms allow states to sidestep traditional diplomatic bargaining and to resolve conflicts through delegation a third party tribunal (Keohane et al., 2000, p. 457). The rationale for focusing on state preferences on these mechanisms is that states create, design and dismantle international dispute settlement mechanisms through international agreements. States are the contracting parties and collective masters of these institutions. State preferences are key to understanding the evolving design of international dispute settlement mechanisms. I assume that state preferences vary in terms of the degree of judicial autonomy granted to international dispute settlement mechanisms (Allee and Peinhardt, 2010; Davis, 2015; McCall Smith, 2000).

Drawing on Zangl's work (2008, p. 828), I assume that variation in judicial autonomy manifests itself in dispute settlement designs in terms of state control over access, process and decision-making. First, states can exert varying control over access and thus use of dispute settlement mechanisms. Some treaties grant only states the right to launch dispute settlement proceedings and only after consultations or agreement of other parties. Hence, states maintain full control of the use and nature of disputes brought under a mechanism. Other treaties – such as Human Rights conventions and BITs – grant non-state actors conditional or unconditional access to international dispute settlement mechanisms. States thereby forgo to some degree control over the use and nature of disputes brought under a dispute settlement mechanism. Second, states can exert varying control over the procedures of dispute settlement mechanisms. Some treaties create institutionalised court-like dispute settlement mechanisms with limited party autonomy and discretion over procedural rules or the selection of adjudicators. In other words, states – as masters of relevant treaties – retain full control and discretion over the procedural rules of dispute settlement mechanisms. Other treaties provide for non-institutionalised ad hoc arbitration with far-ranging party autonomy to choose procedural rules and adjudicators for a dispute. States therefore face uncertainty regarding the dispute settlement process, as they need to jointly agree on an ad hoc basis with the other disputing parties on the applicable procedures and adjudicators. State control over the dispute settlement process is thus limited. Finally, states can exert varying control over the decisions of dispute settlement mechanisms. States have direct and indirect levers to extend or limit judicial autonomy. On the one hand, states can increase or limit their influence on dispute settlement decisions through the drafting of substantive commitments. Detailed language on substantive commitments limits the interpretative leeway of adjudicators in decision-making, while vague language grants adjudicators interpretative leeway. Such variation in *prima facie* substantive provisions has thus procedural ramifications (Jadeau and Gélinas, 2016). On the other hand, states consolidate their influence on dispute settlement decisions under some treaties through veto, review or appellate mechanisms. In other treaties, states relinquish such direct control over decisions.

3. Existing explanations – International collective action problems and power asymmetries

Research on state preferences and dispute settlement designs endorses the conceptual and ontological assumptions of the so-called *open economy politics* (OEP) paradigm (Lake, 2009). States are seen as the preeminent actors in world politics. They aggregate and represent the interests of domestic non-state actors in negotiations with other states and jointly create institutions to advance national interests, increase power and address interstate collective action problems. While states thereby promote integration, they remain the key actors and thus natural analytical focal point of International Political Economy research. Research within the OEP paradigm concentrates on two rationales informing state preferences on dispute settlement designs.

Rational design school

The 'rational design' school stipulates that interstate collective action problems inform state preferences on dispute settlement designs. It endorses a functionalist perspective of international institutions and stands in the tradition of rational choice institutionalism (Davis, 2015; Koremenos et al., 2001; Pelc and Urpelainen, 2015; Snidal, 1985), principal-agent theory (Alter, 2008; Hawkins et al., 2006; Majone, 2001) and liberal institutionalism (Keohane, 1984; Nye, 1988). It builds on the core assumption that states purposefully design international institutions and dispute settlement mechanisms to efficiently resolve collective action problems and political market failures in international affairs such as prisoner's dilemmas, public good, credible commitment or coordination problems (Guzman, 1997; Koremenos et al., 2001; Poulsen and Aisbett, 2013; Snidal, 1985). States are seen to create dispute settlement mechanisms to overcome in particular prisoner's dilemma arising from limited information on state compliance, incomplete contracting and insufficient enforcement capacities in international affairs. Dispute settlement mechanisms ensure neutral third party monitoring, interpretation and enforcement of commitments and thereby increase the chances of Pareto-efficient cooperation.

The 'rational design' school implies that variation in state preferences on the judicial autonomy of dispute settlement mechanisms reflects variation in the specific setup of prisoner's dilemma at hand in a given policy domain, interstate relationship and moment in time. States tailor dispute settlement designs to specific functional challenges and thereby efficiently resolve cooperative hurdles. The reasoning implies that the observed shift in EU and US preferences on ISDS design reflects a re-evaluation of the collective action problems and prisoner's dilemma informing the initial design of ISDS. The markedly different reform strategies and objectives, moreover, suggest that EU and US policy-makers must hold different re-evaluations of the underlying collective action problem and prisoner's dilemma.

Power-based theories

Power-based theories standing in the tradition of neo-realist thought (Drezner, 2007; Nye, 1988; Waltz, 1979) stipulate that interstate power asymmetries determine state preferences on dispute settlement designs. Powerful states are seen to create and design international dispute settlement mechanisms to their advantage while weaker states are coerced into joining them. Power-based theories thus reject the view of international dispute settlement mechanisms as functionalist solutions to collective action problems. Instead they highlight the distributive effects of international institutions and dispute settlement mechanisms on states. International dispute settlement mechanisms are seen as epiphenomenal reflections of interstate power asymmetries without independent causal influence on world politics. Guzman (1997), Poulsen and Aisbett (2013) find that developing countries enter into BITs with ISDS provisions due to their structurally weak position in the world economy. McCall Smith (2000) assesses variation in the dispute settlement designs of free trade agreements. He finds that free trade agreements in highly asymmetric relationships have weak dispute settlement provisions, whereas agreements in symmetric relationships have strong dispute settlement provisions. McCall Smith suggests that powerful states prefer weak diplomatic to strong legalistic dispute settlement mechanisms in asymmetric relationships, as diplomatic channels are sufficient to ensure compliance with an agreement. If both states are similarly endowed with power, however, they prefer strong legalistic dispute resolution through third parties. Simmons (2014), Allee and Peinhardt (2010) elaborate on this reasoning. They find with regard to international investment agreements that powerful states may still favour strong legalistic dispute settlement mechanisms in highly asymmetric relationships, if the mechanisms is primarily used against weaker states and thus – either *de facto* or *de jure* – of non-reciprocal nature.

Power-based theories imply that state preferences on the judicial autonomy of dispute settlement mechanisms vary in function of interstate power asymmetries. State preferences on dispute settlement designs should thus evolve, if the interstate power asymmetries evolve over time. The reasoning implies that EU and US preferences on ISDS design evolved due to a change in their relative power vis-à-vis negotiating partners. More precisely, the EU and US' focus on increasing accountability, legitimacy and the right to regulate stipulates that their relative power must have decreased. The markedly different strategies and targeted reform outcomes, on the other hand, should reflect an uneven reduction in EU and US power in the world economy.

4. A complementary explanation – Non-state actors and institutional legacies

This article builds on the *new interdependence approach* (Farrell and Newman, 2016, 2014) to develop a complementary explanation for evolving EU and US preferences and strategies regarding a reform of ISDS. The *new interdependence approach* takes a step back from the state-centric conceptualisation of the international system present in the OEP paradigm. It highlights that globalisation has fundamentally transformed the international system. The international system has developed from an interstate system where states cooperate and compete to a transnational system where states and non-state actors cooperate and compete. A myriad of overlapping and competing international institutions – grouped together into regime complexes (Alter and Meunier, 2009; Keohane, 1982) – governs the interactions of highly interdependent states, societies and economies. State and non-state actors alike use and shape these overlapping and competing international institutions as opportunity structures to pursue their interests in the most advantageous forum beyond the confines of national institutions and markets. Such venue shopping within the international system can trigger distributive conflicts among states as well as state and non-state actors. The emergence of new opportunity structures and possibilities for venue shopping empower some state and non-state actors but not others, which can unsettle political, social and economic compromises.

The re-conceptualisation of the international system under the *new interdependence approach* has two ramifications for this study. First, transnational interactions between state and non-state actors – for instance through international dispute settlement mechanisms – are deemed causally significant. They shape state preferences and conduct in international affairs. Second, the international system is not an empty space but densely institutionalised. States rarely create international institutions from scratch; but seek to strengthen, weaken or reform existing institutions and regime complexes – including dispute settlement mechanisms – to further their interests. Institutional legacies thus play a significant role in international affairs. Having clarified my conceptual and ontological bases, I now develop my theoretical argument in detail.

Explaining variation in state preferences

I assume that states form preferences on dispute settlement designs in view of their respective costs and benefits. At the most abstract level, dispute settlement mechanisms generate benefits in terms of enhanced compliance of states with international treaties (McCall Smith, 2000, pp. 145–146). High judicial autonomy increases the likelihood that non-compliance of states gets detected and sanctioned. Hence, defection and non-compliance become less attractive. Enhanced compliance with treaty obligations may inter alia promote states' political, economic and normative objectives in international affairs (Elkins et al., 2006; Guzman, 1997; McCall Smith, 2000). Dispute settlement mechanisms, however, also impose costs on states. High judicial autonomy can limit the domestic policy space of states to respond to societal demands and implement public policies without facing political and financial sanctions under dispute settlement mechanisms (McCall Smith, 2000, pp. 144–145).

I assume that variation in dispute settlement design allows states to manage the expected cost-benefit ratio under dispute settlement mechanisms. Design variation is in particular suitable to manage the cost side of this trade-off. The benefits of dispute settlement mechanisms depend to a large extent on the behaviour of third parties – namely other states, traders or investors – and defy direct control. The costs, however, can get directly managed through dispute settlement design. If states anticipate facing a high number of claims and thus high costs in relation to potential benefits, states should favour low levels of judicial autonomy. Low levels of judicial autonomy – through extensive state control over access, process and decisions of dispute settlement mechanisms – enable states to limit their exposure to claims and to contain political and financial costs. If states, however, anticipate facing no or few cases and thus low costs in relation to benefits, states should favour higher levels of judicial autonomy. In this context, high levels of judicial autonomy are unlikely to produce significant costs while enhancing compliance with treaty obligations.

I model state exposure to litigation risks as the independent variable shaping the cost-benefit ratio and thereby state preferences on dispute settlement designs. State exposure to litigation risks depends on three factors. First and foremost, state exposure to litigation risks depends on state compliance with treaty obligations. If states anticipate being fully compliant with treaty obligations, they should expect no or few claims under a dispute settlement mechanism. Second, state exposure to litigation risks depends on the coverage of a dispute settlement mechanism. Conventional international dispute settlement mechanisms grant standing only to a small number of state parties. A growing number of international dispute settlement mechanisms – such as ISDS – grant standing to high numbers of non-state actors, which increases the likelihood of litigation (Alter et al., forthcoming; Parlett, 2011). Finally, state exposure to litigation risks depends on the propensity of potential claimants to use a dispute settlement mechanism. States are hesitant to use dispute settlement mechanisms to safeguard for instance political or military relations with peers (Davis and Shirato, 2007; Zangl, 2008). Non-state actors, on the other hand, are generally more prone to using dispute settlement mechanisms (Pelc, 2017). In sum, state exposure to litigation risks is high, if states fail to comply with treaty obligations and a high number of legal persons have standing and are willing to use dispute settlement mechanisms.

State exposure to litigation risks – and therefore state preferences on dispute settlement design – can evolve. Coverage of dispute settlement mechanisms can vary over time without formal changes to underlying treaties. Exogenous changes may increase or lower the number of legal persons with standing before a dispute settlement mechanism. BITs for instance protect the property rights of foreign investors and grant access to ISDS. A surge in bilateral investment activity results in an increase in legal persons with access to arbitration without any changes to the underlying BIT. What is more, the propensity of potential claimants to use dispute settlement mechanisms can vary over time. International investors for instance barely knew about and used ISDS prior to the late 1990s. In recent years, international investors have grown aware and become avid users of investor-state arbitration. Finally, state compliance with treaty obligations can also vary. Economic downturns or changes in government are known to affect state compliance with international treaty obligations. Explaining these variations goes beyond the scope of this article. It is important to note though that my model suggests that evolving state preferences on dispute settlement designs are not merely a reflection of evolving interstate collective action problems or power asymmetries – as assumed in the OEP paradigm – but reflect evolving transnational interactions between state and non-state actors.

Explaining variation in reform strategies

States' evolving cost-benefit ratios are insufficient to fully account for state preferences on dispute settlement designs. States can lower or increase judicial autonomy of dispute settlement mechanism through incremental or wholesale reform strategies, which produce markedly different design outcomes. Incremental institutional change refers to the reinterpretation of existing institutional norms ('*conversion'*) or the adding of new norms to existing institutions ('*layering'*) (Mahoney and Thelen, 2010, pp. 18–22). While these changes are minor in nature, they can significantly impact on the functioning and effects of institutions on their environment. Wholesale change, in turn, refers to abrupt and radical institutional revisions (*'displacement'*). States replace the institutional core norms and structures in line with intended reform objectives (Mahoney and Thelen, 2010, pp. 18–22). States' choice of reform strategy is thus integral part of the formation of state preferences on dispute settlement designs and in need of explanation.

States select different reform strategies by weighing their costs and benefits. Promoting institutional change is costly (Mahoney and Thelen, 2010; Streeck and Thelen, 2005). States need to invest political capital to overcome opposition at the domestic or international level to advance reforms (Tsebelis, 2002). Incremental and wholesale reform strategies differ in their costs. Wholesale change is typically subject to higher political and legal hurdles and requires greater investment of political capital than incremental institutional change. States should therefore in principle prefer incremental to wholesale reforms to redress the cost-benefit ratio under a dispute settlement mechanism in line with their evolving preferences. Wholesale reforms should only occur, if absolutely necessary to redress states' cost-benefit ratio and attain desired reform outcomes.

I assume that institutional legacies inform states' choice of incremental or wholesale reform strategies and thus function as intervening variable. The previous section identified overall state exposure to litigation risks as the key factor shaping state preferences on dispute settlement design. Here, I elaborate that the concentration/diffusion of state exposure to litigation risks within the institutional foundations of a dispute settlement mechanism shapes states' reform strategies. States' exposure to ISDS-related risks flows from complex networks of mostly bilateral treaties with third countries. State exposure can be highly concentrated in a small number of treaties and relationships. In other words, a state anticipates or faces claims primarily from investors under certain treaties and from certain partner countries within the network. On the other hand, state exposure can be highly diffuse within the treaty network. States anticipate or face claims from investors under various treaties and from diverse partner countries. I assume that the degree of risk concentration within the institutional foundations of a dispute settlement mechanism determines the most efficient reform strategy. The reasoning echoes historical institutionalism, which stipulates that existing institutions circumscribe the preferences, strategies and actions of agents and thereby generate change trajectories (Fioretos, 2011; Mahoney and Thelen, 2010). Thelen and Mahoney note in that regard that "*differences in the character of institutional rules as well as in the prevailing political context affect the likelihood of specific types of change…*" (2010, p. 18). States should favour incremental reform strategies, if their litigation risk is concentrated in a handful of relationships. Targeted incremental reforms such reinterpreting ('*conversion'*) or amending ('*layering'*) dispute settlement provisions in existing and model treaty provisions should be sufficient to mitigate litigation risks and redress cost-benefit ratios. States should opt for wholesale reform strategies, on the other hand, if their litigation risk is highly diffuse within their treaty networks. Incremental and small-scale reforms are likely to be insufficient to manage litigation risks. Instead, states must pursue wholesale reforms ('displacement') to fundamentally reform dispute settlement mechanisms and to redress cost-benefit ratios. The reasoning runs analogous to an engineer dealing with a faulty machine. If a machine is faulty due to a broken component, the engineer will try to repair the machine by fixing the component. If the engineer finds that a machine is faulty due to multiple design flaws, the engineer will try to redesign and replace the machine.

Summary and hypotheses

To sum up, I assume that state preferences on dispute settlement design to hinge on the evolving cost-benefit ratio and notably exposure to litigation risks. States' reform strategy to adjust dispute settlement mechanisms in view of evolving cost-benefit ratios, on the other hand, should depend on the concentration of litigation risks within underlying treaty networks. My model, the rational design school and power-based theories generate testable hypotheses:

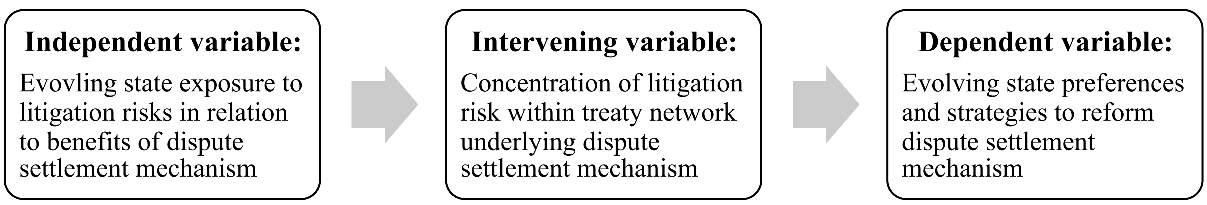
Variation in state preferences

- $H_{1.1}$: If states anticipate low exposure to litigation risks under a dispute settlement mechanism, they should be willing to accept high degrees of judicial autonomy.
- $H_{1.2}$: If states anticipate high exposure to litigation risks under a dispute settlement mechanism, they should seek to limit the judicial autonomy of dispute settlement mechanisms.

Variation in reform strategies

- $H_{2.1}$: If a state's exposure to litigation is high and concentrated within the underlying treaty network, states should pursue incremental reform efforts to redress their cost-benefit ratio.
- $H_{2.2}$: If a state's exposure to litigation is high and diffuse within the underlying treaty network, states should pursue wholesale reform efforts to redress their cost-benefit ratio.

Figure 1: A simplified model



5. Research design and methodological choices

The article treats recent efforts to reform ISDS as representative and significant cases of how states form preferences, design and reform international institutions and more specifically dispute settlement mechanisms. ISDS clauses are among the most frequent international dispute settlement provisions and thus *per se* of interest to any study dealing with international dispute settlement mechanisms. Approximately 3400 treaties provide for ISDS to resolve transnational investor disputes. Almost all states – including unlikely candidates such as North Korea or Somalia – have concluded treaties with ISDS provisions. ISDS can therefore count as the dispute settlement mechanisms with the greatest reach in modern world politics. UNCTAD, moreover, reports 942 known ISDS cases against states making it one of the most frequently used international dispute settlement mechanism in modern world politics (UNCTAD, 2018a). The financial costs tied to ISDS are significant. The historic *Yukos Isle of Man Ltd v Russia* dispute for instance resulted in a preliminary award of US$ 50 billion. ISDS has thus repeatedly dominated the public and policy-making debate in Northern America, Europe and beyond in recent years. In sum, ISDS is not a niche mechanism but stands at the very centre of the universe of international dispute settlement mechanisms.

The article, moreover, treats evolving EU and US preferences and reform strategies as representative and significant for states' approaches to ISDS. The EU, its member states and the US account for more than two thirds of global investment flows and stocks. They invented and promoted treaties with ISDS provisions since the 1950s and are party to almost half of all treaties with ISDS provisions (UNCTAD, 2018a). They are global standard setters and rule-makers in international investment regime. Research indeed suggests that third countries tend to sign up or emulate US or European approaches to investment agreements and ISDS. Assessing the EU and US' approach to ISDS gives insights into the core dynamics shaping global investment regime more generally. To identify EU and US preferences and strategies on ISDS design, the article focuses on model and concluded agreements. It assumes that evolving EU and US preferences are revealed at any assessed time in the most recent model or concluded agreement. It supplants this analysis with legal documents and policy communications clarifying the evolving underlying policy objectives in regard to ISDS. While it is assumed that these sources allow measuring the evolving ISDS design choices of the EU and USA, it is nonetheless clear that previously concluded agreements with older designs of ISDS normally remain in force. Due to the polycentric structure of the international investment regime, policy innovation and reform is slow. It is furthermore important to note that the EU only received the legal competence to conclude international investment agreements under the Treaty of Lisbon in 2009. Before 2009, the individual member states pursued national investment agreement programs and concluded some 1400 BITs. The most active EU member states – in terms of BIT conclusion – were Germany, the United Kingdom, France and the Netherlands, which developed the so-called European 'gold standard' BIT. To assess evolving European preferences on ISDS design, I therefore focus first on BITs of these EU member states and then on the EU post 2009.

The article adopts a comparative research design. Comparing evolving EU and US preferences and strategies provides for sufficient variation in the independent and intervening variables to allow testing my theory. It needs to be mentioned, furthermore, that I consider evolving EU and US preferences and reform strategies as independent cases. ISDS builds on a highly versatile regime complex drawing on bilateral, plurilateral and multilateral legal instruments (Bonnitcha et al., 2017; Dolzer and Schreuer, 2012). Prevalent plurilateral and multilateral arbitration conventions such as the Convention of the International Centre for Settlement of Investment Disputes (ICSID) or the arbitration rules of the United Nations Commission for International Trade Law (UNCITRAL) specify technical aspects of arbitration and enforcement procedures for awards, but states maintain significant leeway to adjust the design of ISDS to their needs through bilateral agreements. What is more, the USA and the EU have negotiated on ISDS in the context of the Transatlantic Trade and Investment Partnership (TTIP) between 2013 and 2015. These negotiations, however, broke down inter alia due to deep-rooted disagreements over the design of ISDS. The TTIP episode suggests that EU and US preferences are indeed independent rather than interdependent cases.

IV. Empirics

Limited exposure to litigation

Modern investment protection agreements with ISDS provisions emerged in the late 1950s and 1960s. The expansion of communism as well as decolonisation movements challenged the property rights of foreign investors and the so-called Hull Doctrine of Customary International Law (CIL) (Vandevelde, 1997, p. 380). The Hull Doctrine stipulated that states were under an international law obligation to ensure the protection of property rights of foreigners and had to pay compensation for expropriations necessary in the public interest. Communist states, however, rejected the notion of private property and engaged in large-scale expropriation of domestic and foreign investors without paying compensation (Vandevelde, 1997, pp. 383–4). Newly independent states, on the other hand, insisted that the expropriation of foreign investors without compensation was lawful and necessary to re-establish national sovereignty (ibid.). In response to the demise of the Hull Doctrine, the so-called old member states of the European Union – notably Germany, France, the Netherlands, Italy and then the United Kingdom – developed modern BITs with ISDS provisions to protect their investors abroad since the late 1950s (ibid.). Today EU member states account for some 1400 of the 3400 BITs in force worldwide (European Commission, 2010). Willing developing countries arguably entered into BITs to signal their commitment to the protection of property rights and to attract capital. Western European states, on the other hand, concluded BITs assuming that these treaties yield economic benefits but result in minimal exposure to litigation and thus costs.

Between the late 1950s and early 2000s, Western European policy-makers saw BITs and ISDS as *de facto* non-reciprocal legal instruments for three reasons. First, the rule of law in Western European states arguably provided for higher levels of property right protection than BITs and ISDS. Outright expropriation was uncommon resulting in a near-zero risk of breaching BIT obligations. Indirect expropriation through regulatory taking, on the other hand, only emerged as a cause for ISDS claims in the 2000s (Pelc, 2017). Second, the propensity of foreign investors to actually use ISDS was deemed low. The first known ISDS case against a host state was filed only in 1987 – some 30 years after the first BIT entered into force (Bonnitcha et al., 2017, p. 59). Investors only started using ISDS more regularly in the late 1990s and 2000s. Third, the coverage of Western European BITs in terms of FDI was marginal until the late 1990s. West European states only concluded BITs with developing countries in the Global South prior to the 1990s. According to UNCTAD statistics, all developing countries accounted for 3.3% of annual global FDI outward flows between 1970 and 1990, while developed OECD economies accounted for 96.7% (UNCTAD, 2018b). Only a fraction of these 3.3% of annual FDI outward flows was protected under Western European BITs. The negligible volume of protected FDI resulted in a near-zero probability of ISDS claims.

Western European BITs and their ISDS provisions echoed this minimal exposure to litigation risks. They exhibited considerable similarity as they were based on the Abs-Shawcross Draft Convention (1959) and OECD's Draft Convention on the Protection of Foreign Property (1967) (Dolzer and Schreuer, 2012, pp. 8–11). First, the BITs of Germany, the Netherlands, France and other Western European states granted foreign investors unconditional access to ISDS (UNCTAD, 2018a). They did not for instance exclude shell companies; contain clauses on the exhaustion of local remedies; or so-called fork-in-the-road clauses to limit investor access to ISDS. Second, Western European BITs granted high party autonomy over the choice of arbitration frameworks and selection of adjudicators for ISDS. European policy-makers meant to give national investors the choice of the most suitable arbitration framework to defend their property rights against developing countries. Finally, Western European BITs foresaw limited state oversight over ISDS decisions. Substantive protection standards – and notably the central Fair and Equitable Treatment (FET) – were vaguely drafted giving investors extensive interpretative leeway – typically in favour of the investor. They did not provide for appellate mechanisms and only minimum review opportunities. In sum, Western European BITs and ISDS provisions were designed to support national investors in developing countries rather than to contain costly ISDS cases against host states.

The USA was a latecomer in the global investment regime. It started negotiating investment protection agreements with ISDS provisions only in 1982 (Vandevelde, 1997). The USA had hesitated to negotiate such agreements as it wanted to safeguard the CIL status of the Hull Doctrine. Its significant geopolitical and military clout, moreover, rendered US investors less vulnerable than European investors to expropriation abroad. Since the early 1980s, however, the USA changed course inter alia due to demands of US Congress and business to level the economic-legal playing field with Western European states (Vandevelde, 2009, pp. 30–82). In the 1990s, the US moreover started using BITs and trade agreements more generally as geopolitical tools to promote and lock-in neoliberal reforms in Latin America and former socialist economies (Chilton, 2016). Today, the USA is party to 50 BITs and comprehensive trade agreements with BIT-like investment chapters (USTR, 2018).

Like Western European states, the USA considered BITs and ISDS to yield economic benefits but to come with no noteworthy litigation risks and costs. US policy-makers and scholars considered the US rule of law to vastly superior levels of investment protection than BITs. The propensity of investors to use ISDS was deemed low. And finally, US agreements covered marginal volumes of FDI inward stocks until the entry into force of the North American Free Trade Agreement (NAFTA) in 1994. Calculations based on OECD data suggests that until the entry into force of NAFTA less than 0.1% of US inward FDI stocks was protected through ISDS (OECD, 2018). The vast majority of US inward FDI stocks came from OECD economies, which had no treaties with ISDS provisions with the USA.

US agreements with ISDS reflected the marginal exposure to litigation risks. They resembled in many regards Western European BITs and indeed relevant draft conventions (Alschner and Skougarevskiy, 2016, p. 565). First, early US agreements grant largely unconditional access to ISDS in case of an investment dispute. Second, they give disputing parties considerable procedural autonomy yet within the framework of the Convention of the International Centre for Settlement of Investment Disputes (ICSID). Early Western European BITs did not limit the choice of procedural frameworks to the ICSID Convention. Third, early US agreements provide for no appellate or review mechanisms to control ISDS decisions. Like early Western European BITs, US agreements were drafted to support US investors rather than to contain states' exposure to litigation.

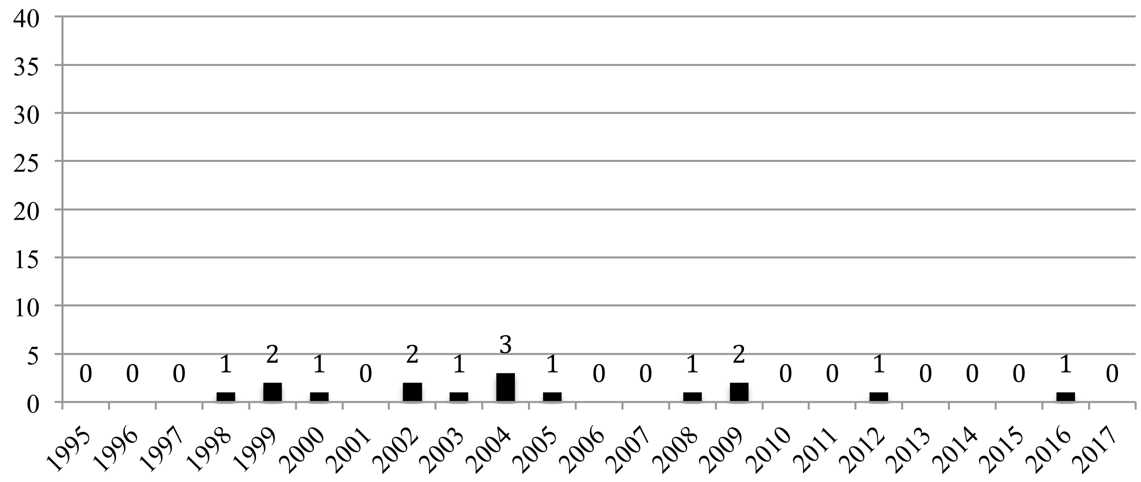
Surging exposure to litigation

US exposure to ISDS-related litigation risks surged in the late 1990s. First, the entry into force of NAFTA (1994) between the USA, Canada and Mexico multiplied the volume of protected FDI inward stocks in the USA. NAFTA grants protection to approximately 10.4% of US inward FDI stocks, while all remaining 49 US agreements with ISDS grant protection to an additional 0.1% of US inward FDI stocks (BEA, 2018; OECD, 2008). Second, the propensity of investors to use ISDS markedly increased in the 1990s (Bonnitcha et al., 2017, p. 25). ISDS transformed into a standard tool for international investors to claim compensation in case of alleged direct and increasingly indirect expropriation (Pelc, 2017). A veritable ISDS infrastructure emerged with specialised law firms and third party funders (Williams and Dafe, 2019).

The surge in US exposure to ISDS-related litigation risks came to the fore in 1998, when the Canadian investor *Loewen* filed the first ISDS claim against the USA under NAFTA after US courts had effectively denied justice in a legal dispute with a national competitor (Matiation, 2003). The New York Times predicted that this "*…precedent could provide a potent back-door way for corporations to challenge the American legal system…"* and would "…"*encourage other companies to try the new tactic…"* (Glaberson, 1999). And indeed within months, the Canadian investors *Mondev* and *Metanex* followed suit and sued the USA. Since then, the USA has been respondent party in at least 16 known ISDS proceedings (UNCTAD, 2018a). All claims against the USA were filled under NAFTA and with the exception of one only by Canadian investors. The USA has not lost an ISDS case so far. It either won or settled with the claimant. Experts, however, stress that the USA was awfully close to losing its first case against *Loewen* (Matiation, 2003).

The surge in ISDS cases triggered a marked shift in US preferences on ISDS design. *Loewen* sent shockwaves through the US administration for its legal merits (Vandevelde, 2009, p. 65). *Metanex*, on the other hand, mobilised the general public and national political establishment. *Metanex* sued the USA over Californian environmental protection regulations, which limited its ability to generate profits, amortise its investment and arguably amounted to indirect expropriation. TV documentaries, national newspapers and magazines and a forceful campaign of NGOs such as Ralph Nader's Public Citizen pointed to *Metanex* to argue that unchecked ISDS constituted a threat to US democracy, rule of law and public policy (Schneiderman, 2013, pp. 80–83). Voters grew concerned and US Congress started looking into the alleged dangers of ISDS. Prominent national politicians such as Senators John Kerry, Max Baucus, Phil Gramm or Allen Gramm led a heated debate in the US Senate on the need to reform the US approach to ISDS and to update NAFTA in order to contain business power and reassert state power in times of globalisation. In the light of these developments, the US government re-evaluated its position on ISDS (Vandevelde, 2009, p. 65). The US government had always seen itself as a capital exporter with offensive interests in the realm of international investment protection. It negotiated ISDS provisions assuming that only US investors would *de facto* use them against developing countries. With first ISDS cases under NAFTA and growing political contestation, the US government came to realise that it was also a capital importer with defensive interests. Canada was the third-largest source of inward investment in the US economy at that time (Vandevelde, 2009, p. 65). Canadian investor could invoke the ISDS clause under NAFTA to defend their interests beyond the confines of the US legal system and potentially inflict high political and financial costs on the US government and taxpayers. The New York Times observed that *"… the United States [was…] to* *restrict access to compensation through Chapter 11 [ISDS]… primarily to insulate the Government from suits…"* (Pritchard, 1999).

Figure 2: ISDS cases against the USA per year



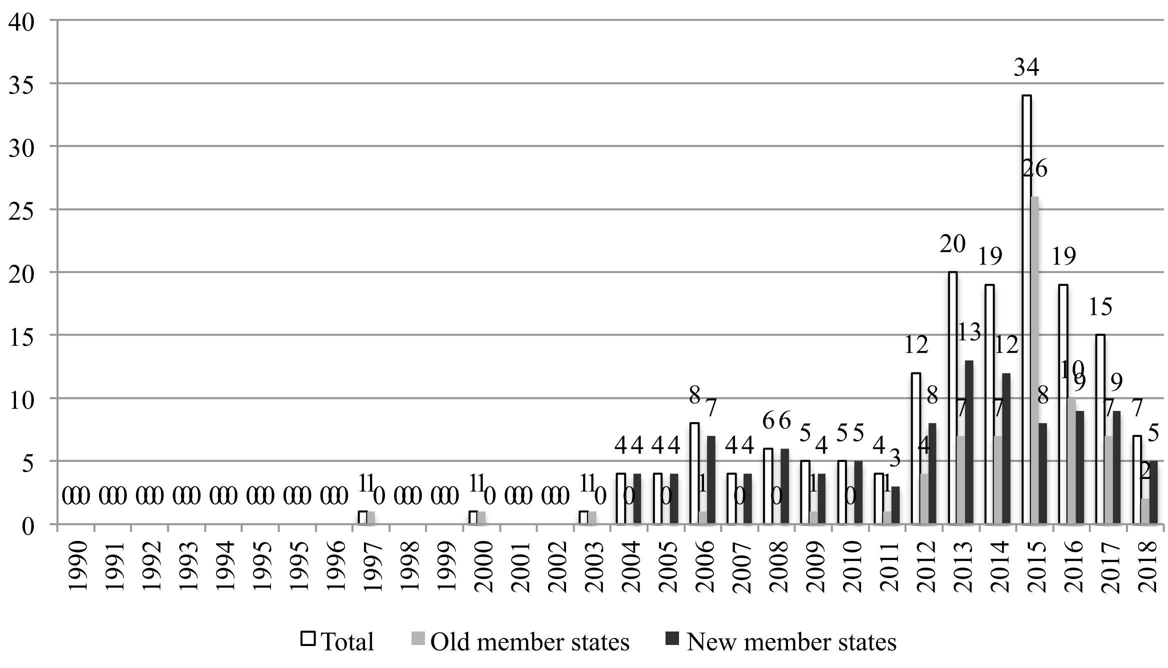
Source: UNCTAD (2018).

Similar developments occurred in the 2000s in the European context. The EU's exposure to litigation risks increased significantly. First, the Eastern Enlargements (2004, 2007) brought several member states with significant shortcomings in terms of legal systems and rule of law into the EU (World Justice Project, 2019). Average state compliance with BIT obligations regarding the protection of foreign investors decreased in the EU making ISDS claims more likely. Second, the Eastern Enlargement also significantly increased the volume of protected FDI within the EU. During the 1990s, old member states concluded hundreds of BITs with Central and Eastern European accession candidates to encourage investment and lock-in neoliberal economic and political reforms. These intra-EU BITs on average protect higher FDI volumes than classic North-South BITs with developing and least developed countries. Calculations based on OECD data (2018) suggests that intra-EU BITs at least triple the volume of protected FDI stocks within the EU. Approximately 14.3% of EU inward FDI stocks are protected through BITs and ISDS. Extra-EU BITs cover 4.6%, while intra-EU BITs cover 9.7% of these inward FDI stocks. These numbers, however, significantly underestimate the volume of protected FDI inward stocks in the EU.[1] The real exposure is significantly higher.

[1] Several reasons account for this underestimation: First, OECD data covers only 21 out of 28 member states and some 90% of EU inward FDI stock. The OECD dataset does not encompass several Eastern and Central European member states, which on average tend to have higher percentages of protected inward FDI stocks. In particular, the dataset lacks data on Cyprus, which serves as investment hub within the European economy. Second, the calculation does not encompass the Energy Charter Treaty as data per country and sector is not available. This Treaty is however the most frequently invoked investment protection agreement in the world and within the EU. Finally, FDI stock data is notoriously unreliable. It is extremely difficult to compute FDI stocks, which means that most numbers are informed guesses rather than proper measurements.

The surge in state exposure translated into a surge in ISDS cases against EU member states. Foreign investors started to regularly bring ISDS claims against EU member states in the mid-2000s (figure 2). One can distinguish two waves of ISDS claims against EU member states. In the beginning, foreign investors primarily sued new member states in Central and Eastern Europe. Most claimants in these cases were investors from old Western European member states using BITs predating the EU's Eastern enlargements of 2004 and 2007. The use of ISDS changed in 2012/2013 with the second wave of ISDS claims against EU member states. Prior to 2012/2013, ISDS cases against old and big member states were highly exceptional. After 2012, however, foreign investors brought claims against Austria, Belgium, Germany, Greece, France, Italy, Luxemburg and Spain (UNCTAD, 2018a). Spain got entangled in 43 ISDS claims in the last years, while Italy had to respond to 11 claims. So while the USA has faced a mere 16 ISDS claims under a single IIA, EU member states have been respondent states in 169 publically known ISDS cases under 84 IIAs. Investors brought 101 cases against new member states and 68 cases against old member states. And while the USA has never lost an ISDS case, investors won 18 cases against EU member states including Spain, Poland, Hungary and Rumania. This number will most certainly rise in the next years with 91 ISDS cases against EU member states pending decision (UNCTAD, 2018a).

Figure 2: ISDS claims against EU member states per year



Nota Bene: The counting does not comprise cases prior to EU accession. Source: UNCTAD (2018).

The explosion in ISDS cases triggered a heated political debate and marked shift in EU preferences on ISDS in recent years. The first wave of ISDS claims in the mid-2000s against new member states still received fairly little political and academic attention (see Eilmansberger, 2009; Van Harten, 2005). The rule of law in many Eastern and Central European member states was perceived as unsatisfactory yet. The use of ISDS to claim compensation for unlawful state treatment thus appeared to be in line with the purpose of BITs and ISDS to supplant deficient legal systems. The situation, however, changed with the second wave of ISDS cases against old and big member states after 2012/13. ISDS emerged as a salient issue in the European public debate namely in the context of the negotiations on the controversial Transatlantic Trade and Investment Partnership (TTIP) between the EU and the USA. The TTIP negotiations were among the very first investment negotiations conducted by the EU – and more precisely by the European Commission – instead of the member states. The main criticism in the consequent public debate was that ISDS unduly shifted the balance of power between state, civil society and multinational business in favour of the latter. Non-governmental organisations, academics, citizens, media and politicians started portraying ISDS as an instrument of multinational corporations to bypass the democratic political process, to circumvent legitimate, effective and efficient courts and to challenge profit-reducing national laws and regulations adopted in the public interest (Siles-Brügge and De Ville, 2016; Young, 2016). They criticised that ISDS gave unique privileges to multinational corporations to the detriment of European taxpayers, democracy and the rule of law. The broad public opposition against ISDS resulted in some of Europe's largest demonstrations since World War II with millions of citizens taking their concerns over TTIP and more precisely ISDS to the streets (Spiegel Online, 2015). In 2014, the European Commission conducted an online consultation on Europe's future approach to ISDS in response to the broad public opposition. The Commission received a record of 150.000 submissions overwhelmingly opposing ISDS (European Commission, 2015). The European Parliament – European co-legislator with veto power over EU trade and investment agreements – consequently adopted a resolution, which called on the European Commission to reform ISDS (European Parliament, 2015). Much like US Congress in the early 2000s, it stressed that if future agreements were to provide for ISDS, they must ensure that ISDS is accountable, legitimate and rebalances defensive state and offensive investor interests. The European Parliament – with the support of member state governments, national and regional parliaments – recommended that the Commission replace conventional ad hoc ISDS through a standing international investment court:

> *"…[a system] which is subject to democratic principles and scrutiny, where potential cases are treated in a transparent manner by publicly appointed, independent professional judges in public hearings and which includes an appellate mechanism, where consistency of judicial decisions is ensured, the jurisdiction of courts of the EU and of the Member States is respected, and where private interests cannot undermine public policy objectives…"* (European Parliament, 2015, p. 15)

Incremental US reforms

The US and the EU – despite similar experiences – endorsed different reform strategies to mitigate ISDS-related risks and costs. The USA started pushing for incremental institutional change through the reinterpretation ('*conversion'*) of IIA provisions in the late 1990s. These reforms aimed at decreasing judicial autonomy in terms of access, process anddecision-making of arbitration panels. The USA – in cooperation with partner countries – started using bilateral/trilateral commissions under relevant IIAs to bindingly reinterpret IIA commitments to that end. In 2001, the USA, Canada and Mexico for instance agreed on two 'interpretations' of NAFTA through the so-called NAFTA Free Trade Commission. This trilateral commission increased procedural transparency requirements to enhance increase accountability and legitimacy of ISDS. It moreover significantly narrowed down the pivotal 'fair and equitable treatment' and 'full protection and security' standards at the heart of investment disputes thereby limiting the interpretative leeway of arbitrators in decision-making. In a similar vein, the USA started submitting legal opinions to arbitration proceedings as non-disputing party to prevent unwanted IIA and NAFTA interpretations. While submissions of non-disputing state parties are not binding on arbitration panels, they carry significant weight notably if disputing and non-disputing state parties agree (Kaufmann-Kohler, 2013).

The USA furthermore pursued incremental change through revisions and amendments ('*layering'*) of relevant legislation, model and existing IIAs. Following the first wave of investor claims against the USA in the late 1990s, the US Congress updated the Trade Promotion Authority Act in 2002. The Act enumerates the core objectives of US trade and investment policy and constitutes a legally binding negotiating mandate for the US government. The Financial Times commented on the updated Act that "*…typically the USA has pushed for the strongest protections acceptable to developing countries. However the new US proposal is aimed at limiting the scope of such investor rights in all future trade agreements."* (Edward Alden, 2002). The Act stipulates that IIAs should ensure that US investments abroad enjoy similar levels of protection as investments within the USA but that foreign investors do not gain greater rights than domestic investors in the USA (United States Congress, 2002, p. 63). ISDS provisions should moreover contain mechanisms to discard frivolous claims, provide for transparent and accountable proceedings, allow trade union, NGOs and alike to submit so-called *amicus curia* letters. The Act suggested that the USA should in the long-run aim for the creation of an appellate body to increase coherence and accountability of ISDS. The 2002 Trade Promotion Authority Act echoed the debates in the US Congress following the *Metanex* case (Schneiderman, 2013, pp. 80–83). In 2015, US Congress maintained and reiterated these investment policy objectives in its follow-up legislation. The US government accordingly updated its model investment agreements inter alia in 2004 and 2012, which featured a *"…massive revision of investor-state disputes provisions…"* (Vandevelde, 2009, p. 590) to ensure policy coherence and align them with the Trade Promotion Authority Acts. The model agreements served as negotiating template and strongly influenced the draft text of inter alia for the Transpacific Partnership (TPP) of 2015 (Nottage, 2015). Finally, the US government under President Trump pushed for a reform of NAFTA and notably its ISDS provisions. In 2018, the NAFTA parties announced that the successor agreement – the so-called US-Mexico-Canada Agreement (USMCA) – would limit investor access to ISDS and the interpretative leeway of arbitrators in decision-making. USMCA maintains ISDS in US-Mexican investment relations but forecloses ISDS in US-Canadian relations. It, furthermore, limits the use of ISDS to direct expropriation claims and does not provide for the 'fair and equitable treatment' standard at the heart of most investment disputes. While of incremental nature, US reforms manifestly seek to limit judicial autonomy of arbitration panels and state exposure to investment disputes (USTR, 2019).

Wholesale EU reforms

European policy-makers started pushing for ISDS reforms only in the last ten years. The EU's late preoccupation with ISDS reforms reflects that most EU member states faced investment disputes only recently (figure 2). Following in particular the growing public contestation of investment protection and ISDS in the context of the TTIP negotiations in 2012/13, the EU developed at first incremental and then wholesale reform strategies to mitigate ISDS-related risks and costs. The EU's incremental reform efforts become apparent when comparing model BITs of France (2006), Germany (2008), the Netherlands (2004), Italy (2003) and the United Kingdom (2006) with equivalent provisions in the final texts of the EU-Canada Comprehensive Economic and Trade Agreement (CETA) and the EU-Singapore Free Trade Agreement (EUSFTA). The EU's revisions aim at limiting judicial autonomy through greater state control over access, process and decision-making of arbitration panels. In terms of access, EU agreements seek to limit access to ISDS through a narrower definition of investors and investment to prevent so-called treaty shopping, a prohibition of parallel proceedings before national courts and ISDS tribunals and mechanisms to discard frivolous claims unfounded as matter of law (European Commission, 2016). In terms of process, EU agreements seek to render ISDS proceedings more accountable and legitimate and to increase the weight of public policy considerations through greater transparency, amicus curiae letters and new provisions relating to the selection, qualifications and ethics of arbitrators (European Commission, 2016). Finally, in terms of control over decision-making, EU agreements circumscribe the interpretative leeway of arbitration tribunals through more detailed language on treatment standards (Jadeau and Gélinas, 2016), a mechanism for parties to adopt binding interpretative guidelines and finally the creation of appellate mechanisms in the form of a so-called Investment Court System. The comparison suggests that the EU follows – and exceeds in many regards – incremental US reforms to rebalance offensive and defensive state interests.

The EU, moreover, advocates wholesale institutional reform through the displacement of conventional ad hoc ISDS through a standing multilateral investment court. Following demands from the European Parliament and member states, the Commission published in 2016 a proposal to create such a court under the umbrella of the United Nations (European Commission, 2016). This court shall ensure accountable, legitimate and coherent dispute resolution mindful of states' right to regulate and public policy considerations. Dispute settlement in the international investment regime shall thus become more similar to dispute settlement in the WTO in the international trade regime. The Commission stresses that the EU's novel Investment Court System, which informs the investment chapters inter alia of CETA and EUSFTA, is a nucleus and stepping-stone toward a multilateral investment court. The Investment Court System constitutes a complex *inter se* modification between the EU and partner countries of major arbitral frameworks such as the ICSID Convention. It introduces a number of court-like features into conventional ad hoc ISDS (Reinisch, 2016). It requires the disputing parties for instance to select arbitrators from a closed list of vetted, qualified and de facto tenured adjudicators. It moreover creates a standing appellate mechanism to review controversial awards and ensure coherence in jurisprudence (annexe 1). The EU's Investment Court System, however, hinges on bilateral and plurilateral agreements and cannot replace multilateral efforts to create a standing court. The Commission and the member states – with the support of Canada, Vietnam, Mauritius and others – have thus formally proposed the opening of negotiations on a multilateral investment court within the United Nations Committee on International Trade Law (UNCITRAL) (Roberts, 2018). Other countries such as the USA, Japan and China show limited interest in the proposal or signal opposition. It remains to be seen whether the EU's efforts to bring about wholesale institutional reform of ISDS will succeed.

Diverging exposure and concentration of litigation risks

The EU and US' diverging choices of reform strategies can get traced back, on the one hand, to their different levels of exposure to litigation risks. The EU and its member states are much more exposed to litigation risks than the USA. While EU member states have entered into some 1400 agreements with ISDS provisions, the USA is party to a mere 50 agreements. These starkly different numbers – while not neatly correlated – translate into different volumes of protected FDI. EU agreements protect at least 14.3% of inward FDI stocks. The real volume of protected inward FDI stocks in the EU is much higher but impossible to compute because of data limitations. Once EU member states terminate intra-EU BITs in accordance with recent EU jurisprudence, the volume of protected FDI may fall to 4.6%. US agreements protect 10.8% of inward FDI stock. Once USMCA has entered into force, this value will fall below 1%. The greater volume of protected inward FDI in the EU than in the USA results – in combination with lower levels in the rule of law notably in Central and Eastern European members states (World Justice Project, 2019) – in higher numbers of investment disputes against EU member states. EU member states have faced 169 and lost 18 investment disputes with 92 pending, while the USA has faced a mere 16 investment disputes and lost none (UNCTAD, 2018a). These numbers point to significant costs for states. OECD research suggests that disputing parties incur on average legal fees of US$ 8 million (Gaukrodger and Gordon, 2012, p. 71). UNCTAD moreover reports that investors win 61% of ISDS cases after assessment of the legal merit and that the average investor award amounts to US$ 504 million while the mean award comes to US$ 20 million (UNCTAD, 2018c, p. 5). It becomes clear from these facts that the EU and its member states incur significantly higher costs and risks under the *status quo* than the USA. Hence, European policy-makers are more willing than their US counterparts to invest political capital to advance far-reaching and costly ISDS reforms.

Table 1: EU and US exposure and concentration of litigation risks

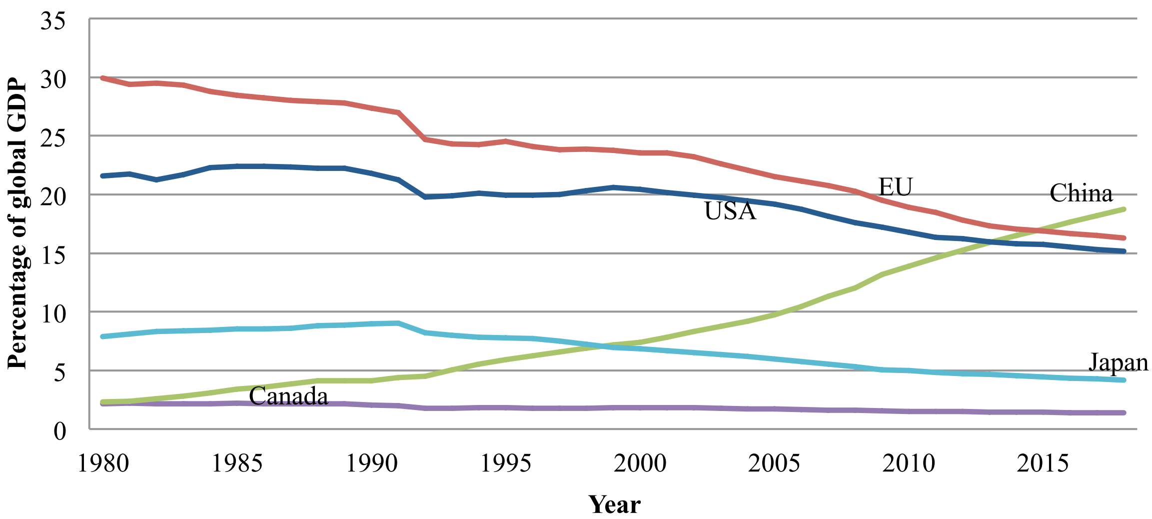
	USA	**EU and member states**
Number of investment treaties with ISDS provisions	50	1400
FDI stock protected	10.8%	< 14.3%
ISDS claims	16	169
ISDS claims lost	0	18
Number of investment treaties invoked for ISDS claims	1	84

The EU and US' diverging choices of reform strategies, on the other hand, echo the starkly different degrees of concentration of litigation risks and costs within their respective treaty networks. EU member states have been facing investment disputes under 84 different treaties with ISDS provisions. The most frequently invoked investment treaty is the plurilateral Energy Charter Treaty. Investors brought 65 of the 169 claims against EU member states under the Energy Charter Treaty. The USA, however, has faced all its investment disputes under NAFTA. Canadian investors brought fifteen and Mexican investors one case against the USA. The different degrees of concentration of litigation risks and costs within their treaty networks determine efficient reform strategies available to EU and US policy-makers. While EU policy-makers face diffuse and significant litigation costs and risks, US policy-makers face highly concentrated and limited litigation costs and risks. EU policy-makers thus need to resort to more encompassing and systemic approaches to ISDS reform, while US policy-makers can focus primarily on managing and incrementally reforming NAFTA. A former legal officer of the US State Department commented that incremental reforms of NAFTA were the most efficient and effective strategy to mitigate ISDS-related risks for US policy-makers and taxpayers (Interview, 11 September 2018).

Assessing alternative explanations

Evidence by and large supports my explanation for evolving state preferences and diverging reform strategies. In the following section, I empirically assess the validity of alternative explanations to solidify my argument. The 'rational design' school (Keohane, 1984; Koremenos, 2016; Koremenos et al., 2001) offers a parsimonious explanation for variation in the design of international institutions and dispute settlement mechanisms. It implies that states alter their preferences and seek to reform international institutions and dispute settlement mechanisms, if the underlying interstate collective action problems evolve and require institutional adjustments to ensure the continued effective resolution of collective action problems. While intuitive, the USA and EU's recent efforts and diverging reform objectives regarding ISDS are difficult to reconcile with this logic. The collective action problems, which informed the invention of investment agreements and ISDS in the 1950s and 1960s, have not evolved. Western European states invented BITs and ISDS to overcome compliance, monitoring and enforcement problems, which may result in a hold-up of investment activity and foregone economic growth. This rationale has not changed. Recent statements by US and EU authorities emphasise the continued importance of ISDS as a mechanism to ensure the protection of investors abroad (European Commission, 2019, 2016; European Parliament, 2015; USTR, 2018). Policy-makers clearly hold on to ISDS as a credible commitment device to overcome compliance, monitoring and enforcement challenges in the international economic relations. The 'rational design' school, which explains evolving state preferences on dispute settlement designs through evolving perceptions of interstate collective action problems, thus cannot account for EU and US preferences and reform efforts. What is more, it equally fails to explain diverging reform strategies. Evolving and varying perceptions of interstate collective actions problems can barely explain the US and EU's preferences for incrementally reformed ISDS or a permanent multilateral investment court under the umbrella of the UN.

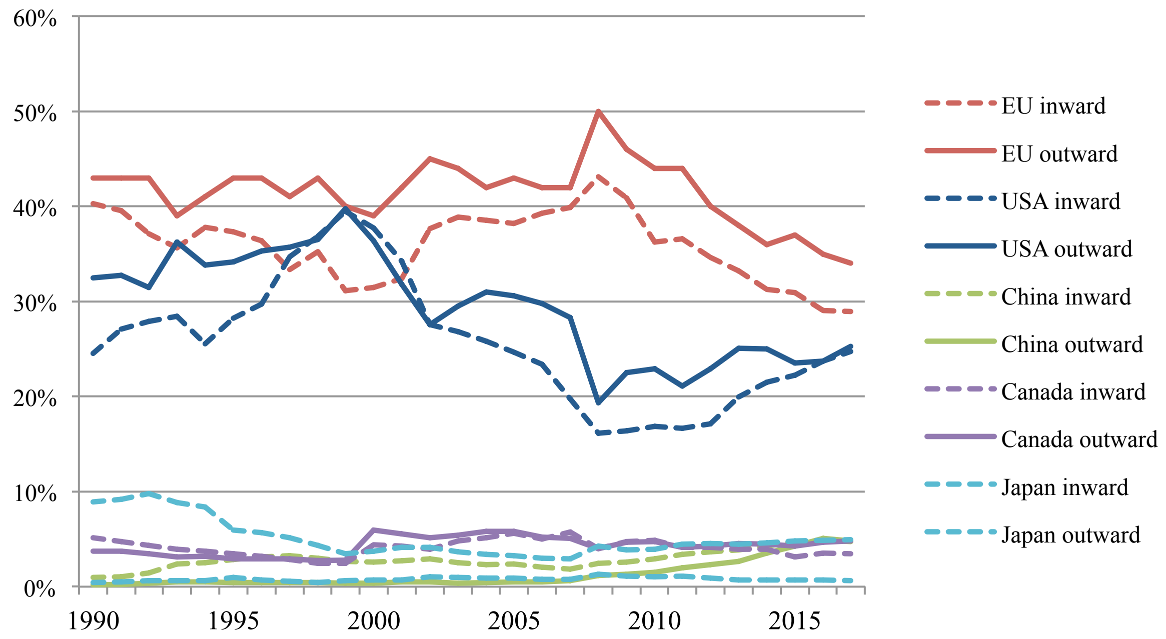
Figure 4: Share of global GDP in purchasing power parities for selected economies



Source: IMF (2018).

Power-based theories are intuitive and have great explanatory reach. Like rational design explanations, they have shortcomings though, which become apparent with regard to the EU and US' recent efforts to reform ISDS. First, power-based theories stipulate that states' design preferences regarding international institutions and dispute settlement mechanisms evolve, if states' relative power positions vis-à-vis other states evolve. In other words, if states gain or loose in power in the international system, they adjust their design preferences and seek to reform international institutions and dispute settlement mechanisms. The EU and the USA have lost in economic power in some respects, which may at first sight explain recent reform efforts. The most frequently used measure of economic power is the gross domestic product (GDP) in global comparison. GDP is seen, on the one hand, as a proxy for the overall size of a national market and therefore states' ability to inflict opportunity costs on third countries by granting or withholding market access. On the other hand, GDP is tied to state capacity and ability to strategically project economic power in the international system (Drezner, 2007). The EU and the USA have seen a marked reduction of their share in global GDP in purchasing power parities pointing to diminishing economic power (figure 1). This development is, however, strongly tied to the rise of the Chinese economy. The economic power asymmetries between the EU, the USA and partner countries in recent investment negotiations – such as Canada, Japan, Singapore or Mexico – have not significantly changed. The share in global GDP of the USA, EU, Canada, Japan and others has been diminishing to similar degrees over the last years. An assessment of other relevant power proxies leads to similar conclusions. The share of economies in global inward and outward FDI stocks for instance should point to the ability of economies to act as standard-setter and rule-maker rather than rule-taker in the international investment relations. High inward FDI stocks suggest that economies are hubs for global firms and production networks, whereas high outward FDI stocks imply that economies are important emitters of capital and know-how in the world economy. The EU and the USA's share in global inward and outward FDI stocks have shrunk over the last years (figure 2), but they still control 74% of the global outward FDI stock and 65% of the global inward FDI stock (UNCTAD, 2017). Other economies – including China – still trail far behind. These observations cast serious doubts over the validity of power-based explanations for recent EU and US efforts to reform ISDS. What is more, power-based theories cannot account for the diverging reform preferences of the USA and the EU. Power-based theories imply that states' design preferences are tied to their relative economic power position in the international system. In other words, states with similar power endowments should favour similar design features of international institutions and dispute settlement mechanisms. As the data shows (figure 4 & 5), the USA and the EU have similar economic power endowments. As this article documented, the USA and the EU pursue markedly different reform strategies. Power-based theories thus clearly miss an important part of the picture.

Figure 5: Inward and outward FDI stocks as percentage of global stocks for selected economies



Source: UNCTAD (2017).

V. Conclusion and outlook

Research the design of international institutions and dispute settlement mechanisms is rooted in the OEP paradigm (Lake, 2009). It focuses on interstate collective action problems and power asymmetries to explain variation in state preferences on dispute settlement designs. While generally intuitive and of proven explanatory power, these approaches fail to offer compelling explanations for recent EU and US' efforts to reform ISDS. Drawing on the new interdependence approach (Farrell and Newman, 2016, 2014), I develop a complementary explanation focusing on non-state actor litigation and institutional legacies to explain evolving state preferences and strategies to reform ISDS. Transnational interactions between state and non-state actors within complex institutional regimes rather than classic interstate interactions shape ISDS design. Empirical evidence confirmed my theory and points to the significance of transnational and institutional dynamics shaping the design of international institutions and dispute settlement mechanisms. An important finding of this study is then that the *new interdependence approach* indeed offers a compelling analytical and conceptual framework to understand the evolution of the international investment regime and ISDS. The international investment regime and ISDS indeed constitute new opportunity structures for state and non-state actors to pursue their interests beyond the confines of national institutions and to directly engage with each other. Yet, these opportunity structures are only available to certain state and non-state actors, shift the balance of power in society and trigger redistributive conflicts within states and among states. US and EU debates illustrate how the rise of BITs and ISDS has mobilised the transnational business community, civil society actors and state authorities in attempts to re-shape the international investment regime and ISDS.

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Annexe 1: Comparative table of member state model BITs, CETA, EUSFTA and ICS proposal

Functional focus of provisions	Provision	Provision in member state model BITs	Article no. in BIT	Provision in EU trade and investment agreements (CETA, EUSFTA, ICS)	Article no. in EU agreement	Policy rational behind adjustments in EU agreements
Access to ISDS	Definition of covered investor and investment	Broad definition	DE: 1 FR: 1 NL: 1 IT: 1 UK: 1	Narrow definition requiring 'substantial business activity' and barring 'mailbox' and 'shell' companies from ISDS	CETA: 8.1 EUSFTA: 1.2.5	Limit access to ISDS
	Parallel proceedings	No provisions governing parallel proceedings before courts and arbitration tribunals	DE: - FR: - NL: - IT: - UK: -	'Fork on the road' clause prohibiting parallel proceedings requiring investors to chose between national courts and ISDS	CETA: 8.2.2.f EUSFTA: 3.7.f	Limit access to ISDS
	Frivolous claims	No provisions to prevent frivolous claims unfounded in the matter of law	DE: - FR: - NL: - IT: - UK: -	Mechanism to discard 'frivolous claims' without legal basis and to recover legal costs	CETA: 8.32 EUSFTA: 3.14	Limit access to ISDS
Conduct of ISDS proceedings	Transparency requirements	References to standard arbitration rules, which provide for little to no mandatory transparency	DE: - FR: - NL: - IT: - UK: -	Compulsory use of UNCITRAL transparency rules	CETA: 8.36 EUSFTA: 3.16 & Annexe 8	Increase social legitimacy and accountability of ISDS
	Amicus curiae letters	No codified right of third parties to submit opinions to arbitral tribunal	DE: - FR: - NL: - IT: - UK: -	Obligation on arbitral tribunals to consider amicus curiae letters	CETA: 8.36 EUSFTA: 3.16 & Annexe 8	Increase social legitimacy and accountability of ISDS
	Selection of arbitrators	Parties are free to nominate arbitrators in line with standard arbitration rules of ICSID, UNCITRAL and alike	DE: 10 FR: 7 NL: 9 IT: 10 UK: 8	Parties select arbitrators from a roster of vetted qualified judges	CETA: 8.29.7-8 EUSFTA: 3.6, 3.44	Ensure that arbitrators have a public law background and are sensitive to states' challenges and duties
	Code of conduct for arbitrators	Reference to standard arbitration rules, which do not contain	DE: - FR: - NL: - IT: - UK: -	Judges subscribe to a code of conduct circumscribing their external legal activities	CETA: 29.8 & Annexe 29.B EUSFTA: 3.11 & Annexes 7, 11	Ensure that arbitrators do not face incentives to rule in favour of investor interests
Control of arbitral	Fair and Equitable	Concise and vague definition of fair and equitable treatment	DE: 2 FR: 3	Detailed definition clarifying the treatment standard and potential	CETA: 8.10 EUSFTA: 2.4	Limit the interpretative leeway of arbitrators to

awards	Treatment standard[2]		NL: 8 IT: 2 UK: 2	violations		safeguard states' right to regulate
	Mechanisms for the adaption of binding interpretative guidelines	No mechanism built into member state model BITs	DE: - FR: - NL: - IT: - UK: -	Committee under relevant treaty to adopt interpretative guidelines for arbitral tribunals	CETA: 8.10 EUSFTA: 2.4	Limit the interpretative leeway of arbitrators to safeguard states' right to regulate
	Appellate mechanism for arbitral awards	None; standard review of arbitral awards as provided under ICSID Convention or national law of arbitration seat	DE: - FR: - NL: - IT: - UK: -	CETA creates a standing appellate body to review awards and ensure coherence; EUSFTA foresees future creation of such a mechanism	CETA: 8.28 EUSFTA: 3.12	Limit the interpretative leeway of arbitrators to safeguard states' right to regulate

[2] The 'Fair and Equitable Treatment' clause is a substantive treatment and protection standard. The EU's efforts to clarify the meaning of the standard and potential violations have, however, procedural effects on ISDS. As Jadeau and Gélinas (2016) observe, the clarifications seek to limit the interpretative leeway of arbitration tribunals and thereby to ring-fence states' right to regulate.