The Fiscal Impacts of Investment Provisions in United States Trade Agreements

A study prepared for Taxpayers for Common Sense by
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May 14, 2002

Executive Summary

The U.S. Senate is currently debating trade promotion authority (TPA) legislation that would grant U.S. trade negotiators broad discretion to include so-called "investor protection" provisions in future trade agreements with other countries. These provisions would allow foreign investors operating in the U.S. to sue the U.S. government for financial compensation based on federal, state or local government actions. Citing evidence from the North American Free Trade Agreement (NAFTA), critics of TPA have expressed concern that future trade agreements could subject the United States to financial liability based on legal standards that go well beyond the established interpretations of the Takings Clause of the Fifth Amendment and other provisions of the U.S. Constitution. Like the similar and highly contentious domestic "takings" legislation that Congress has debated in recent years, the trade bill raises a concern about the ways in which increasing the public's financial liability could adversely affect taxpayers and the fiscal health of our governments.

This study by the Global Development and Environment Institute, an economic research institute at the Fletcher School of Law and Diplomacy of Tufts University, attempts to estimate the potential fiscal costs of "investor protection" provisions in future international trade agreements. Because estimating the value of potential claims involves many inescapable uncertainties, the authors have employed a predictive methodology that is as conservative as possible. Based largely on an extrapolation from experience under NAFTA, the study estimates that "investor protection" claims under international trade agreements could expose U.S. taxpayers to claims totaling **up to $32 billion on an annual basis –the equivalent of three-fourths of the annual federal block grants to state and local governments.** The financial obligation created by investor-protection claims would fall directly on the federal treasury, but they could indirectly threaten federal funding of many state and local government programs. The prospect of imposing this new fiscal burden on U.S. taxpayers should be cause for grave concern during this period of national emergency and serious budget shortfalls.

Background

Last December, by a single vote, the U. S. House of Representatives passed a trade promotion authority bill (formerly called "fast-track" negotiating authority) that would give the President broad power to negotiate future trade agreements. Very soon, the U.S. Senate is expected to take up trade promotion authority (TPA) as well. TPA allows the administration to pursue trade negotiations subject to the understanding that, once the agreements have been signed, Congress can not amend them but must hold an up-or-down vote on each agreement as a whole.

The pending bill before the Senate grants U.S. trade negotiators broad authority to include new provisions in future trade agreements allowing foreign investors to sue for damages for "expropriations" or for denials of "fair and equitable treatment." These provisions would allow foreign investors operating in the U.S. to sue the United States for money based on federal, state or local government actions. Significantly, while these so-called "investor protections" are supposed to be interpreted "consistent with United

States legal principles and practice," there is no requirement in the pending bill that the final standards in the trade agreements conform to the actual text and established interpretations of the U.S. Constitution.

A number of public officials, policy-makers, and members of the public have expressed concern about the inclusion in future trade agreements of so-called "investor protection" provisions. These provisions allow foreign investors operating in the U.S. to sue the United States for monetary damages based on federal, state or local government actions. Based in part on experience under the North American Free Trade Agreement, critics of TPA have expressed concern that future trade agreements could subject the United States to financial liability based on legal standards that go well beyond the established interpretations of the Takings Clause of the Fifth Amendment and other provisions of the U.S. Constitution. This expanded liability could, according to the critics of TPA, impose a major new fiscal burden on the U.S. treasury.

This study attempts to estimate the potential fiscal costs of "investor protection" provisions in international trade agreements to U.S taxpayers.

Takings-like proposals such as these have consistently raised the concern, particularly among state and local officials, that they might impose significant new burdens on taxpayers. Previous studies of some proposed takings measures that were ultimately not passed have looked at the potential fiscal impacts:

- At the national level, the Office of Management and Budget estimated that the financial burdens imposed on U.S. taxpayers by the takings provisions in the "Omnibus Property Rights Act of 1995," could amount to $4 billion annually.[1]
- In the State of New Mexico, a study estimated that a 1993 takings bill might impose a financial burden of between $2.6 and $8.8 million annually on the budget of New Mexico Department of Game and Fish.
- An October 2000 report analyzing the fiscal impacts of a takings measure on state and local government in Oregon found that the measure, if interpreted to require the City of Portland to pay to enforce its urban growth boundary, could cost the city over $3 billion annually.
- A1995 study of takings legislation in New Hampshire estimated that the pending bill would have imposed between $2 million and $8 million on local governments annually.

This study of the possible adverse fiscal impacts of the "takings" and other "investor protection" provisions in international trade agreements is in keeping with prior efforts to evaluate the public policy implications of expanding government's takings liability. The primary difference between the international "investor protection" provisions and domestic takings legislation is, of course, that the provisions in trade agreements apply only to foreign investors, and grant no new rights to U.S. citizens against their own government.

[1] These OMB estimates were for a House version of the bill. It was estimated that the Senate version would cost several times more than the House version. See Alice Rivlin's testimony, S. Hrg. 104-239, http://thomas.loc.gov/.

NAFTA's Chapter 11 Cases

NAFTA's Chapter 11 includes a wide range of investment liberalization and investor protection provisions. One controversial provision of NAFTA, which is roughly analogous to the Takings Clause of the Fifth Amendment, allows foreign investors to sue for compensation based on regulatory actions deemed to be "expropriations," "indirect expropriations," or "tantamount to expropriation." Another provision grants investors a right to sue for monetary damages based on actions which violate the international law standard of "fair and equitable treatment" According to many observers, these provisions expand upon U.S. standards for liability or, in any event, are so uncertain in scope that they could easily be interpreted to extend beyond U.S. law.[2]

One frequently cited example is a successful $16.7 million settlement of a claim against the government of Mexico based on a Mexican municipality's decision to prevent a U.S. company from opening a hazardous waste facility, on the grounds that it failed to comply with Mexican regulations. Closer to home – and with a much larger price tag – is a pending suit for $1 billion filed by the Canadian Methanex Corporation, claiming that a California effort to protect groundwater by banning the use of MTBE as an additive to gasoline represents a "taking" under international law.

Methanex is a Canadian firm that manufactures methanol, one of the principal components of methyl tertiary butyl ether (MTBE), a gasoline additive. Citing studies indicating that MTBE can contaminate drinking water, in March 1999 the State of California issued a ban on MTBE in all gasoline sold in the state by the end of 2002. Later in 1999, Methanex filed a claim for $1 billion alleging that the ban will result in a loss of future profits, and that Methanex did not receive fair treatment under the law.

The dollar amount of Chapter 11 claims against North American governments, especially considering the fact that NAFTA only went into effect a few short years ago, has been impressive. Table 1 summarizes the known investor-state complaints from 1995 to 2002. To date there have been twenty-one claims filed, for a total of $3.1 billion. While the United States has been the defendant for the highest level of financial claims, totaling $1.8 billion, relative to the size of their economies Canada and Mexico have been harder hit. Claims against Canada equal $976 million, while Mexico has been sued for more than $249 million.

All the claims against the United States have been brought by Canadian corporations, and range from a $20 million claim by the Kenex corporation, to the highly publicized $1 billion Methanex case. The average claim against the U.S. is $377 million ($177 million for all NAFTA claims).

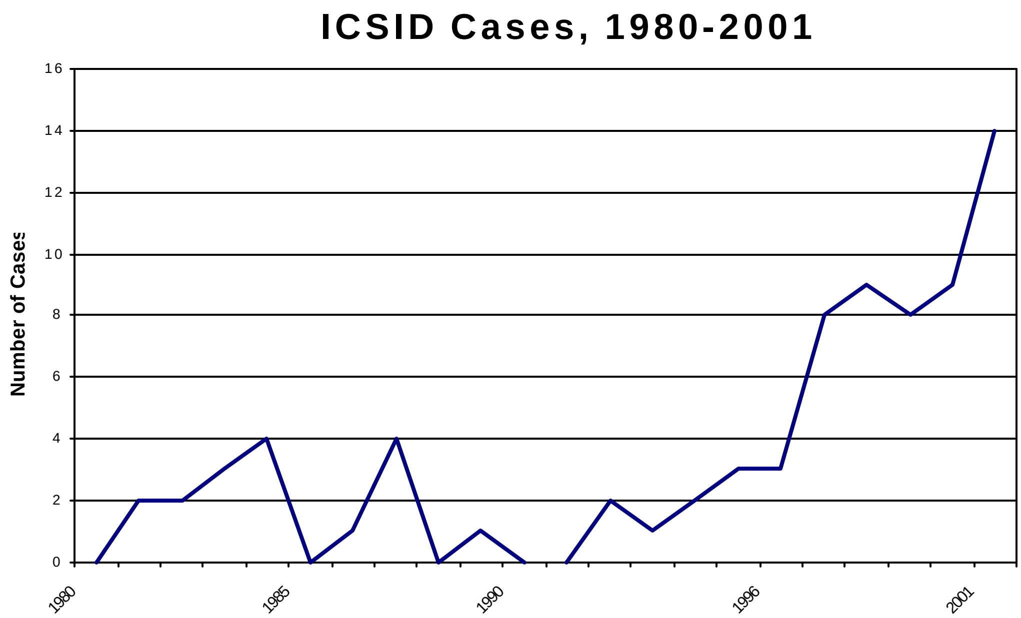
[2] *See, e.g.*, International Institute for Sustainable Development, *Private Rights, Public Wrongs: A Guide to NAFTA's Controversial Chapter of investor Rights* (2001).

Table 1. Investor-to-State Complaints Under NAFTA Chapter 11

	Plaintiff / Investor	Home Country	Total Claimed	Business Sector / Cause of Action
Against the United States	A.D.F. Group	Canada	$90 million	Steel Products – unfair Govt. procurement policy.
	Kenex, Ltd.	Canada	$20 million	Industrial Hemp products – discrimin. govt. policy
	Loewen Group	Canada	$725 million	Funeral homes and insurance - punitive damages
	Methanex	Canada	Approx. $1 billion	Gasoline additive – phase out
	Mondey, Intl.	Canada	$50 million	Real estate development - contract breach
Total Claims Against the United States: $1.885 billion				
	Plaintiff/ Investor	**Home Country**	**Total Claimed**	**Business Sector / Cause of Action**
Against Canada	Crompton Corp.	United States	$100 million claim	Chemical Products – restraint on seed tmt. products
	Ethyl Corp.	United States	$251 million claim $13 million sttlmt.	Gasoline additive - ban on x-border transport
	Ketchum & Tysa	United States	$30 million claim	Forestry – different quotas in different provinces
	Pope & Talbot	United States	$130 million claim	Forestry - different quotas in different provinces
	S.D. Meyers	United States	$20 million claim,	Waste mgmt - ban on cross border.
	Signa	Mexico	$33 million claim.	Pharmaceuticals - no approval.
	Sun Belt Water	United States	$220 million claim (changed to$1.5 – $10 billion claim)	Surface water - export ban.
	Trammel Crow	United States	$32 million claim	Real Estate Mgmt. – unfair denial of contract.
	UPS	United States	$160 million claim	Courier delivery services – monopoly of postal svc.
Total Claims Against Canada: $976 million				
	Plaintiff / Investor	**Home Country**	**Total Claimed**	**Business Sector / Cause of Action**
Against Mexico	Adams et al.	United States	$75 million claim	Resort Development – expropriation
	Calmark	United States	$ 400 K claim	Commercial Development – unauth. prop. transfer
	Robert Azinian (Desona)	United States	$19 million claim	Waste mgmt - contract breach.
	Feldman (Karpa)	United States	$50 million claim	Tobacco import - no tax rebate.
	Halchette	United States	not disclosed	Airport concession
	Metalclad	United States	$65 million claim, $16.7 million award	Waste mgmt - no permit.
	Waste Mgmt. #1 & #2.	United States	$60 million claim	Waste mgmt
Total Claims Against Mexico: $269.4 million				
Total Claims Against All Countries: $3.130 billion				

Source: www.naftalaw.org (in order to provide a conservative estimate of the fiscal implications of trade legislation, we have assigned a value of $220 million to Sun Belt Water's claim against the Canadian government. However, it is noteworthy that this claim has reportedly been increased to between $1.5 to $10 billion.).

Figure 1. Cases Brought Before ICSID, 1980-2001



Source: International Centre for the Settlement of Investment Disputes (ICSID)

The $1.8 billion in claims against the U.S. are a small but not insignificant proportion of U.S. imports and foreign direct investment (FDI) from Mexico and Canada. Claims against the U.S. equal one-tenth of a percent of the $1.5 trillion of imports from Mexico and Canada between 1996 and 2000, and 2 percent of the $85 billion in foreign direct investment (FDI) from our two NAFTA partners.

According to some legal and political observers, these types of claims will become more frequent with the growth in the number of trade agreements. As evidence they cite the number of investor disputes that have been brought before the International Centre of Investment Disputes (ICSID) at the World Bank. ICSID tracks investor disputes from a number of investment treaties. Figure 1 shows the rate of claims filed at ICSID from 1980 to 2001. From 1980 to 1995, the annual number of claims ranged from zero to four. Between 1996 and 2001, the period when NAFTA Chapter 11 cases started, the number of annual claims increased sharply, reaching 8 by 1997 and 14 last year. These trends suggest that investment agreements, once seen as defensive measures to protect corporations in extreme circumstances, such as the nationalization of oil reserves, are now becoming offensive measures that are in some cases being used to challenge the development of regulations in the public interest.

Estimating Potential Economic Impacts of Future Investor Protection Provisions in U.S. Trade Agreements

In this section, we attempt to estimate the potential dollar value of claims that could be triggered by future trade agreements with investor protection provisions similar to the investor protection provisions in NAFTA's Chapter 11. We then juxtapose our estimates alongside major federal budget outlays to demonstrate the magnitude of the estimated fiscal impacts.

The TPA is intended to accelerate negotiation of two major trade accords: the "Doha Round" of the global trade talks under the World Trade Organization (WTO), and the Free Trade Area of the Americas (FTAA) --a proposed agreement between 34 nations in the Western Hemisphere. Both agreements are scheduled for completion in 2005, the same year that TPA would expire if it were enacted this year.

In many ways, estimating the number and scale of future claims under future U.S. trade agreements is a difficult and imprecise exercise. Although we know future claims are inevitable, reliably predicting the number and value of the claims that will be asserted against the United States involves many inescapable uncertainties. We have thus decided to employ a predictive methodology which is as conservative as possible. Our dollar figures generated by this analysis should not be considered precise predictions, but rather as rough cost estimates designed to illustrate the likely order of magnitude of potential claims.

As Table 1 indicates, we estimate that the annual value of claims against the U.S. could range from $10 billion (assuming claims are proportional to imports) to almost $32 billion (assuming claims are proportional to foreign investment). These estimates, the details of which are described below, are calculated by making three assumptions:

1. Potential claims from non-NAFTA partners will be proportional to the claims against the U.S. from NAFTA partners during the period 1996 to 2000.
2. The rate of growth in potential claims in 2001-05 will be equal to the growth rate of total NAFTA claims during the period 1996 to 2000.
3. The rate of growth of U.S. imports and U.S.-bound foreign direct investment will be a modest 10 percent over the period 2001 to 2005 (i.e., 2 percent per year).

The most plausible starting point for estimating the potential magnitude of the potential claims against the United States is to assume that future claims by non-NAFTA trading partners will be proportional to those under NAFTA. As indicated earlier, the U.S. expects to complete FTAA and WTO negotiations by 2005. Draft text for the FTAA which has been released to the public includes Chapter 11-like investment provisions, and there have been indications that the WTO round will include such provisions as well. For these reasons, we have calculated worldwide potential claims by extrapolating from the magnitude of the claims filed under NAFTA.

Table 2: Potential Future Claims on the U.S. government (million U.S. dollars)				
Estimate based on:		Five-year totals 1996-2000	2001-2005	Annual cost 2001-2005
Imports				
	NAFTA	1,885	14,193	
	FTAA	479	3,604	
	WTO	5,032	37,890	
	Total:	6,917	52,083	10,417
FDI				
	NAFTA	1,885	14,193	
	FTAA	552	4,153	
	WTO	19,265	145,050	
	Total:	21,150	159,242	31,848

Source: Economic information from U.S. Bureau of Economic Analysis; claims information from www.naftalaw.org; extrapolations by authors explained below. Note that for the purposes of this calculation, estimates for FTAA exclude NAFTA; WTO excludes NAFTA but includes all other FTAA. Thus world totals are NAFTA + WTO; the amounts shown here for FTAA are included in WTO estimates.

The $1.8 billion in claims against the U.S. under NAFTA from 1996 through 2000 is one-tenth of one percent of the $1.5 trillion in U.S. imports from Mexico and Canada during that five-year period. Alternatively, claims against the U.S. from NAFTA partners amount to 2 percent of total FDI from those countries during the same time span. Thus our two basic estimates assume either that future potential claims against the United States will be one-tenth of one percent of U.S. imports worldwide, or alternatively 2 percent of foreign direct investment ("FDI") from the rest of the world into the U.S. Our calculations can be interpreted as counter-factual estimates of the value of claims that might have been filed by FTAA and WTO trading partners if such nations enjoyed investor agreements with the U.S. similar to those found in NAFTA.

The upper and lower portions of Table 2 perform parallel calculations, first assuming claims are proportional to imports, then assuming they are proportional to FDI. Starting with the upper, import-based numbers, the figures $479 and $5,032 billion in the first column of Table 2 indicate the dollar amount of claims that would have been filed by *exporters* from FTAA and WTO nations (excluding NAFTA) during 1996 to 2000. That is, these figures represent one-tenth of one percent of total U.S. imports from FTAA and WTO nations (minus Mexico and Canada). The "total" figure of $6,917 billion represents the value of claims that would have been filed by all foreign exporters (this time including NAFTA) from 1996 to 2000, if they had the same level of claims as our NAFTA partners in proportion to their exports to the U.S.

This same exercise is performed in the lower half of the first column with respect to FDI. The value of NAFTA claims against the United States was 2 percent of FDI from Mexico and Canada between 1996 and 2000; the FTAA and WTO estimates assume the same relationship between potential claims and FDI from the rest of the world. Since NAFTA is the source of about one-fourth of U.S. imports, but only one-tenth of FDI in the U.S., the world total is quite a bit larger in the FDI-based estimate: $21,150 billion for 1996-2000. Since claims can be filed either by foreign investors or exporters, the $6,917 billion trade-based figure and the $21,150 billion investment-based figure can be interpreted as a range of potential claims that could have been filed if all of our trading partners had Chapter 11-style agreements with us.

The second column of Table 2 projects future claims for the subsequent five-year period, using both the import-based and the FDI-based methods, and adding two sources of growth. First, we assume that imports and FDI into the U.S. will grow at 2 percent annually, or 10.4 percent for the five-year period, slower than the growth rates generally assumed in analyses by the International Monetary Fund and other agencies.

Second, we assume that the rate of increase in claims against the U.S. from 2001 to 2005, per dollar of imports or FDI, will equal the rate of increase in claims against all three countries of NAFTA from 1995-96 to 2000-01. The existence and potential impact of the Chapter 11 mechanism is not yet well known, even within NAFTA; it seems reasonable to assume that recent growth in claims represents a learning process that is not yet completed, indeed not yet slowing down. The dollar amount of claims in the last two years was 6.82 times the amount in the earlier two years.

To obtain our second column, therefore, we multiplied our first column by 6.82 (and also multiplied it by 1.104 to reflect five years of 2 percent annual economic growth). The results are our estimates for potential claims on the U.S. by NAFTA, FTAA, and WTO partners between 2001 and 2005, comparable to the 1996-2000 estimates in the first column. Our estimates of total potential claims between 2001 and 2005 are $52,083 billion in the case of possible claims from foreign exporters, to $159,242 billion from foreign investors. On an annual basis, as shown in the third column, this translates to $10,417 to $31,848 billion – in round numbers, between $10 billion and $32 billion. While this extrapolation from NAFTA indicates exposure to a possible $32 billion a year, many experts feel that actual exposure could be far greater, citing the possibility that significant successful claims will encourage and generate even more claims.
These figures, though conservatively estimated, are truly alarming considering the fact that they only include forecasts of potential claims. We know that the legal fees and associated costs (that will fall directly on states and localities) could also be very high. While we do not know how much the State of California is spending on the Methanex case, we do have estimates based on past takings claims. While conducting such extrapolations is beyond the scope of this study, it is entire plausible to warn that such costs would amount to millions of dollars for each state on an annual basis.

Table 3. Annual Potential Claims as a Percentage of U.S. Budget	Budget Outlays ($ U.S. billions)	Potential Claims as Percent of Budget Outlays
Agriculture	75.7	28%
Commerce	7.8	269%
Defense—Military	281.2	7%
Education	33.9	62%
Energy	15	140%
Health and Human Services	382.6	5%
Housing and Urban Development	30.8	68%
Interior	8	263%
Justice	19.6	107%
Labor	31.4	67%
State	6.8	309%
Transportation	46	46%
Treasury	391.2	5%
Environmental Protection Agency	7.2	292%

Source: Budget figures for year 2000: Source: http://www.whitehouse.gov/omb/budget/fy2002/msr07.html#table14; potential claims are the midpoint of the annual range in Table 2 ($21 billion).

Table 4. Potential Claims as a Percentage of Federal Transfers

Transfers to:	**Transfer Amount ($ U.S. billions)**	**Potential Claims as Percent of Transfer**
State Governments	238.9	9%
Local Governments	31.7	66%
Block Grants*	42.9	49%

Source: *Block grants are special funds to both state and local governments, and are included in column one totals for state and local governments and thus not included in the "total" column. Data for Block Grants from Congressional Research Service, "Block Grants: An Overview," January 21, 2001. State and Local outlays from U.S. Census Bureau, "Census of Governments." Potential claims are the midpoint of the annual range in Table 2 ($21 billion).

Table 3 juxtaposes the midpoint of our potential claim range ($21 billion) as a percentage of total FY2000 budget outlays for major departments in the U.S. government. Twenty-one billion dollars is larger than the entire budgets of all but a handful of U.S. departments.

Many officials in state and local governments are concerned that large new federal government liabilities arising from state and local government actions may trigger the federal government to begin withholding transfer funds to states and localities. Table 4 juxtaposes the midpoint of our annual potential claim range ($21 billion) as a percentage of Federal transfers to state and local governments. Potential claims could amount to 9 percent of total outlays to states, and 66 percent of all outlays to local governments.

Furthermore, the magnitude of the potential claims is almost one-half of the total annual amounts of federal block grants from the federal government to state and local governments on an annual basis. Block grants, which accrue to both state and local governments to address broad purposes such as community development, transportation, and law enforcement, usually amount to $42 billion annually. The biggest annual block grant is "Temporary Assistance to Needy Families," and amounts to $16 billion. Other large block grants that receive over $3 billion annually are the "Federal Mass Transit: Urbanized Area Formula Program," the "Surface Transportation Program," and the "Community Development Block Grants."

Deriving Potential Future Claims from Recent Takings Reform Studies

Another way to extrapolate the potential costs of investment provisions in future trade agreements would be to assume that widespread takings reform would occur across the U.S. The economic and fiscal impacts of expanded interpretations of U.S. takings law have long been a concern of policy-makers and economists. A number of studies of such impacts were conducted in the mid 1990s during debates over reforming "takings" laws under the U.S. Constitution. The range of potential claims extrapolated from the actual NAFTA record in the last section is quite small in comparison to estimates that can be derived from those earlier “takings” studies. To err on the side of caution we use the NAFTA-based estimates.

Legislative takings proposals were introduced in at least 43 states in the 1990s. Most of those bills required compensation by state and local governments to owners of private property in the U.S. A handful of studies attempted to measure the economic impacts of these bills, and reported that takings claims could impose a significant fiscal burden on those governments that enacted them.

Two of these studies deserve note. In New Hampshire it was estimated that takings claims could amount to $2 million to $8 million annually for selected local governments in that state, or 34 to118 percent of the total budgets in the localities that were studied (RKG, 1995). A similar study was done to evaluate takings legislation on a statewide basis in the state of Washington. That study concluded that the cost (over an indefinite period of time) of potential takings in the state could be up to $1.8 billion for all the cities in Washington, and $7 billion for all counties (IPPM, 1994).

Table 5. Potential Claims on the U.S. Government (Takings Method)

Study derived from:		Per Capita ($)	Annual U.S. Total ($U.S. millions)
New Hampshire			
	Low	440	123,945
	High	1,609	452,897
Washington			
	Low	305	85,943
	High	1,188	334,223

Source: All population figures from U.S. Census Bureau; New Hampshire Study, "The Cost of Takings Legislation to New Hampshire Taxpayers," RKG Associates, 1995; Washington Study, "Referendum – 48: Economic Impact Study of the Property Rights Initiative," Institute for Public Policy and Management, University of Washington, 1996.

As shown in Table 5, in both the New Hampshire and Washington reports, the per capita costs of takings legislation for the affected communities range from $305 to $1609 depending on the number of regulations assumed to be subject to the law. Scaling these figures up to the entire U.S. population, Table 5, potential damages range from $85 billion to $452 billion annually. These estimates dwarf the $10 billion to $32 billion reached in the previous analysis.

Conclusion

If future trade agreements between the United States and its trading partners include "investor protection" provisions modeled after those in NAFTA , foreign investors will certainly bring numerous claims against the United States. For a variety of the reasons discussed above, it is extremely difficult to estimate the precise amount of such claims. We believe that few involved in the public debates over NAFTA predicted that the investor protection provisions in that agreement would produce, in just a few years, billions of dollars in claims (and counting). Our estimate, which we believe to be conservative, is that trade agreements negotiated under the TPA will produce claims (on the low side) totaling $10 billion annually and (on the high side) $32 billion annually.

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The authors would like to thank Luke Ney for his research assistance on this project.

This report was prepared for Taxpayers for Common Sense (TCS). TCS is a non-partisan voice for American taxpayers. TCS is dedicated to cutting wasteful spending and subsidies in order to achieve a responsible and efficient government that lives within its means.

Taxpayers for Common Sense would like to thank the John W. Merck Fund for their financial support of this report.

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