

# MULTIPLE AUTHORISATION: THE LEGAL COMPLEXITY OF *DESENTRALISASI* IN INDONESIA AND THE POTENTIAL CONTRIBUTION OF IIAS IN REDUCING CONFUSION

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## Abstract

*Decentralisation system in Indonesia was introduced after the fall of the former President Soeharto with the objective of ensuring good governance and equitable development across all regions in the country. Unfortunately, the implementation of desentralisasi has been complicated. Some scholars have suggested that the model was flawed as it did not consider Indonesia's context of less developed administrative institutions in the regions. Not only did desentralisasi cause headaches for the government, it also created confusion for foreign investors. Consequently, it affects the investment climate in the country and undermines the perception of Indonesia as an attractive place to invest in. In certain cases, desentralisasi has also led to claims by foreign investors for investor-State arbitration under Indonesia's international investment agreements (IIAs). This paper analyses the problems of desentralisasi in Indonesia, its effects to foreign investors and suggests ways to alleviate the problems by modifying and using Indonesia's IIAs effectively.*

**Keywords:** decentralization, due process, international investment agreements, Indonesia

## Abstrak

*Setelah jatuhnya rezim Soeharto, sistem pemerintahan desentralisasi mulai diterapkan di Indonesia dengan tujuan untuk memastikan tata kelola yang baik dan pembangunan yang adil di seluruh wilayah Republik Indonesia. Sayangnya, penerapan desentralisasi sangatlah sulit. Beberapa akademisi mengatakan bahwa model sistem desentralisasi yang diterapkan di Indonesia tidak sesuai dengan situasi di lapangan di Indonesia, khususnya di daerah-daerah yang belum mempunyai kantor-kantor administratif yang berfungsi dengan baik. Desentralisasi menimbulkan berbagai masalah bagi pemerintah dan membingungkan para investor asing. Akibatnya, desentralisasi memperburuk iklim investasi di Indonesia dan menimbulkan persepsi negatif mengenai Indonesia sebagai tempat berinvestasi. Dalam beberapa kasus tertentu, desentralisasi juga menyebabkan munculnya tuntutan-tuntutan oleh para investor asing di arbitrase antara investor dan Pemerintah berdasarkan perjanjian investasi internasional (PII) Indonesia. Makalah ini menganalisa masalah-masalah yang ditimbulkan oleh desentralisasi di Indonesia, efek-efeknya bagi para investor asing dan memberikan saran mengenai cara-cara untuk menangani beberapa masalah tersebut dengan mengubah dan menggunakan PII Indonesia secara efektif.*

**Kata Kunci:** desentralisasi, due process, perjanjian investasi internasional, Indonesia

## I. Introduction

For the last 50 years, Indonesia has undergone various transformations, from the chaotic period at the end of Sukarno's old order, different phases of Soeharto's New Order which ended during the 1997-1998 Asian financial crisis, aftermath of the crisis, the post-crisis reform period, and the more recent times of relatively stable economic growth. Across these years, Indonesia's economic policy, including trade policy, has been at best explained as ambivalent and ineffective.<sup>1</sup> As Indonesia seeks to sustain its economic growth amid the volatile global economic climate, the government has taken several strategies in both investment and trade sectors, including aggressively sourcing capital from abroad so as to bring in foreign direct investments (FDI) into the country. The government understands that in order to bring in more FDI, it must improve the investment climate in the country,<sup>2</sup> including upgrading its obsolete infrastructures. In terms of physical infrastructure, various projects to lower transportation and production costs have commenced since President Joko Widodo's inauguration.<sup>3</sup> Indeed, some of these projects are FDI funded.<sup>4</sup> Nevertheless, the progress in the development of the infrastructure projects have been hampered by a lack of coordination and bureaucratic inefficiencies – the soft infrastructure if you will.<sup>5</sup>

In this paper, we focus on the issue of soft infrastructure, particularly the issue of *desentralisasi* which has been the subject of intense criticism and debate by businesses, government officials, as well as academics. Nasution suggests that the core problem of *desentralisasi* in Indonesia is the wrong choice of a decentralization model which is not in accordance with the actual conditions in the country.<sup>6</sup> Since the introduction of *desentralisasi*, the central government has less control over policy implementation. The regional governments have the upper hand in budgeting and policy-making at the regional level.<sup>7</sup> Unfortunately they do not seem to be well equipped with strong analytical capacity to work in harmony with the central government in creating and implementing sound investment policy.<sup>8</sup>

Indeed, this has been the story of decentralisation in South Africa as well.<sup>9</sup>

<sup>1</sup> Mari Pangestu, Sjamsu Rahardja, and Lili Yan Ing, "Fifty years of Trade Policy in Indonesia: New World Trade, Old Treatments," *Bulletin of Indonesian Economic Studies* Vol. 51 Issue 2 (2015): 239-241.

<sup>2</sup> On how International Investment Agreements (IIAs) can contribute to the rule of law in a country, see Michael Ewing-Chow, Junianto James Losari and Melania Vilarasau Slade, "The Facilitation of Trade by the Rule of Law: The Cases of Singapore and ASEAN" in Marion Jansen, MS Jallab, and Maarten Smeets (eds), *Connecting to Global Markets* (Geneva: WTO, 2014), p. 129-46, [http://www.wto.org/english/res\\_e/booksp\\_e/cmark\\_chap9\\_e.pdf](http://www.wto.org/english/res_e/booksp_e/cmark_chap9_e.pdf), accessed 2 December 2015.

<sup>3</sup> Winarno Zain, "President Jokowi's Infrastructure Projects: Quantity vs Quality," *Jakarta Post* (23 February 2015), <http://www.thejakartapost.com/news/2015/02/23/president-jokowi-s-infrastructure-projects-quantity-vs-quality.html>, accessed 2 September 2015.

<sup>4</sup> Erlangga Djumena, "China Pours Rp 645 Trillion for Indonesia's Infrastructure (Garap Infrastruktur Indonesia, Tiongkok Gelontorkan Rp 645 Triliun)," *Kompas* (25 April 2015) <http://bisniskeuangan.kompas.com/read/2015/04/25/214600826/Garap.Infrastruktur.Indonesia.Tiongkok.Gelontorkan.Rp.645.Triliun>, accessed 2 September 2015.

<sup>5</sup> CNBC, "Indonesian infrastructure promises derailed by bureaucrats," CNBC (18 July 2015) <http://www.cnbc.com/2015/07/18/indonesian-infrastructure-promises-derailed-by-bureaucrats.html>, accessed 2 September 2015.

<sup>6</sup> Indra Kesuma Nasution, "The Challenge of Decentralization in Indonesia: Symmetrical and Asymmetrical Debate," *Int'l Journal of Social Science and Humanity* Vol. 6 Issue 9 (2016): 691.

<sup>7</sup> Pangestu, Rahardja, and Yan Ing, *op.cit.*: 251.

<sup>8</sup> *Ibid.*

<sup>9</sup> Donald L. Horowitz, *A Democratic South Africa: Constitutional Engineering in a Divided Society* (California: University California Press, 1991); see also Donald L. Horowitz, "Indonesia's Distinctive Path to

Decentralisation was introduced to the South African constitution in 1994 to ensure democratic decision-making from the grassroots level upwards, citizen participation in both democratic structures and developmental debates, and appropriate vehicles for the establishment of democratic legitimacy to the new democratic dispensation.<sup>10</sup> Yet, after more than a decade since its adoption, the regional governments remain in a state of paralysis with service delivery failure and dysfunction.<sup>11</sup>

Grindle and Manor argue that the failure of the system can be attributed to its excessively complicated design which is based on a set of underlying assumptions that are simply not applicable in the South African case.<sup>12</sup> Koelble and Siddle's findings confirm such arguments. Indeed, the South African institutional design was painstaking and based on international best-practice experience. However, other key intervening factors such as effective local institutions, accountable political processes, effective local autonomy and authority, and adequate resources are necessary for the design to be transformed into effective governance.<sup>13</sup> Koelble and Siddle also agree with the suggestion that decentralization must be introduced on the basis of an existing and functioning civil service—which was not the case in South Africa at the time.<sup>14</sup> The regional governments, as the developmental arm of the central government, need to be equipped with technical, financial and administrative staff that are up to the difficult task of policy implementation. Unfortunately, this apparatus was not created soon after the introduction of decentralisation due to oversight.<sup>15</sup> Furthermore, the existing accountability mechanisms across all levels of government have been ignored, leading to misappropriation of funds, elite capture and corruption and a general lack of service provision.<sup>16</sup>

The South African experience in many ways is similar to the experience of Indonesia. In this paper we identify the problems of *desentralisasi* in Indonesia. We note some critics have suggested various ways to improve *desentralisasi*, including improving the institutional design and modifying the laws. For this reason, our analysis is more focused on how international investment agreements (IIAs) with investor-State dispute settlement mechanism (ISDS) may contribute to alleviating some of the problems. We are not suggesting that only with the IIAs that the problems can be resolved. However, since Indonesia already has numerous IIAs and is planning to renegotiate its old BITs, we simply provide recommendations on how to maximize the potential contribution of the existing IIAs in dealing with some of the problems of *desentralisasi*, as well as how to formulate new IIAs that recognize the issue of *desentralisasi*.

## II. Indonesia's Desentralisasi in a Nutshell

Prior to decentralisation, between the late 1950s and the late 1990s, the government structure in Indonesia was centralised. Both Soekarno and Soeharto saw

Constitutional Democracy," (Presented at Conference on Comparative Constitutional Design, 16-17 October 2009).

<sup>10</sup> Thomas A Koelble and Andrew Siddle, "Institutional complexity and unanticipated consequences: the failure of decentralization in South Africa," *Democratization* Vol. 21 Issue 6 (2014): 1117.

<sup>11</sup> *Ibid.*

<sup>12</sup> *Ibid.*: 1118.

<sup>13</sup> *Ibid.*

<sup>14</sup> *Ibid.*

<sup>15</sup> *Ibid.*: 1119.

<sup>16</sup> *Ibid.*: 1129.

regionalism as a major threat to Indonesia's survival as a unitary State. For this reason, the central government controlled all the regions and imposed uniform administrative structures and procedures across Indonesia.<sup>17</sup> The capital did not tolerate local leaders or organisations that resisted the policies of the central government.<sup>18</sup> However, this policy of centralisation later changed dramatically.

Decentralisation is defined as:

*the transfer of responsibility for planning, management and resource raising and allocation from the central government and its agencies to: a) field units of central government ministries or agencies; b) subordinate units or levels of government; c) semi autonomous public authorities or corporations; d) area wide, regional or functional authorities; or e) non-governmental private, or voluntary organisation.*<sup>19</sup>

Article 1(e) of Law No. 22/1999 on Regional Governments defines *desentralisasi* as the delegation of authority to govern and regulate, from the central government to regional governments within the unitary State of the Republic of Indonesia. The system was introduced in 1999 after the fall of President Soeharto. In 1999, the Parliament passed Law No. 22/1999. This law was perceived as one of the compromises to prevent the disintegration of the nation as various regions of Indonesia, including Aceh, Riau, Irian Jaya, felt that the central government—which used to fully control all sectors—had not paid enough attention to their development.<sup>20</sup> The system of *desentralisasi* was expected to ensure that the regional governments would accommodate the interests of the people and optimize the development in the regions.<sup>21</sup>

Under this system, authority is delegated to at least 31 different areas, including education, youth and sports, health, public works, environment, housing, investment, small and medium enterprises, population, labour and transmigration, women empowerment, family planning, transportation, communication and information, land ownership, rural empowerment, maritime and fisheries, agriculture, plantation, forestry, mining, tourism and culture, industry, and trade.<sup>22</sup> Nevertheless, the central government maintains the sole authority for a list of certain areas, including foreign policy, defence, security, judicial, monetary and fiscal, and religion.<sup>23</sup>

Ideally, *desentralisasi* should increase the efficiency of public services, the effectiveness of governance, and the promotion of democracy.<sup>24</sup> The architects argued that shifting authority to the sub-provincial level would promote democratisation because communities would be more aware and engaged with local politics. By

<sup>17</sup> Edward Aspinall and Greg Fealy, "Introduction: Decentralisation, Democratisation and the Rise of the Local," in Edward Aspinall and Greg Fealy (eds), *Local Power and Politics in Indonesia: Decentralization and Democratization* (Singapore: ISEAS, 2003), p. 2.

<sup>18</sup> *Ibid.*

<sup>19</sup> Dennis A. Rondinelli, John R. Nellis, and G. Shabbir Cheema, "Decentralization in Developing Countries: A Review of Recent Experience," Working Paper 581 (World Bank) (1983).

<sup>20</sup> Nasution, *loc.cit.*

<sup>21</sup> Syamsuddin Haris (ed), *Decentralization and Regional Autonomy (Desentralisasi dan Otonomi Daerah)* (Jakarta: LIPI, 2007), p. 152.

<sup>22</sup> Indonesia (1), Undang-Undang tentang Pemerintahan Daerah (Law regarding Regional Governance), UU No. 32 Tahun 2004, LN No. 125 Tahun 2004 (Law Number 32 Year 2004, SG No. 125 Year 2004), arts. 13 and 14.

<sup>23</sup> *Ibid.*, art. 10(3).

<sup>24</sup> Djohermansyah Djohan, "The Policy of Decentralization in Regional Governance in Indonesia (Kebijakan Desentralisasi Dalam Penyelenggaraan Pemerintahan Daerah di Indonesia)" *Jurnal Pamong Praja* Vol. 1 (2012): 1–2.

bringing decision-making to this level, communities would be keener to participate and at the same time, they could also hold politicians accountable for their actions.<sup>25</sup> Much of these proposals were modelled on systems with significantly better regional institutions than Indonesia's.

Ever since they were first proposed, Indonesian *desentralisasi* laws have been controversial. The critics argue that the laws would lead to a declining quality of governance and would undermine national cohesion. Some critics observed several elements that would undermine the quality of governance, including the lack of capacity at the regional level, growing inequalities between rich and poor regions, and worsening corruption and money politics.<sup>26</sup> Horowitz argues that some of these inherent problems are mere anomalies.<sup>27</sup> However, Tomsa opines that if they were really anomalies, Horowitz should have provided a more comprehensive evaluation of decentralisation process that takes into account both achievements and failures, as well as suggestions to resolve the so-called anomalies.<sup>28</sup>

While it may have had worthy objectives, as predicted, the implementation of *desentralisasi* has been proven to be a headache for the central government. The newly elected local legislatures in 1999 and the regional bureaucracies were ill-equipped and lacked of capacity. This is because they had been subject to a decades-long culture of top-down control that stifled initiative and allowed little scope for public consultation.<sup>29</sup> *Desentralisasi* has also resulted in conflicting policies and regulations between the central government and the regional governments,<sup>30</sup> and it provides more opportunities for corruption.<sup>31</sup>

### A. Corruption and Abuse of Power

*Desentralisasi* shifts some of the decision-making power from the central government to the regional governments. Some sceptics' predictions that corruption would increase due to *desentralisasi* have come true. Instead of having a single Soeharto ruling at the central level, 'little Soehartos' appeared at the regional level.

Regional leaders are often alleged to abuse their positions to obtain bribes from businessmen who seek to win infrastructure projects funded by the governments. Recently, Alstom, a French engineering giant, was charged in the United States under the Foreign Corrupt Practices Act and paid a fine of approximately USD 772 million to the US Department of Justice for various corruption charges, including bribing Indonesian officials to win a bid for the construction of an electricity generation plant

<sup>25</sup> Aspinall and Fealy, *op.cit.*, p. 4.

<sup>26</sup> *Ibid.*, p. 5.

<sup>27</sup> Donald L Horowitz, *Constitutional Change and Democracy in Indonesia* (Cambridge: Cambridge University Press, 2013), p. 141.

<sup>28</sup> Dirk Tomsa, "Review: Donald L Horowitz: *Constitutional Change and Democracy in Indonesia*," *Journal of Current Southeast Asian Affairs* Vol. 32 Issue 1 (2013): 149-152.

<sup>29</sup> *Ibid.*

<sup>30</sup> Direktorat Otonomi Daerah (Bappenas), *Analysis in Formulating Mid-term Policies for Revitalizing Decentralization and Regional Autonomy Processes 2010-2014* (Kajian Perumusan Arah Kebijakan Jangka Menengah Bidang Revitalisasi Proses Desentralisasi dan Otonomi Daerah Tahun 2010-2014), (Jakarta: Badan Perencanaan dan Pembangunan Nasional 2009), p. IV-74.

<sup>31</sup> Chairul Akhmad, "Mahfud MD: Regional Autonomy is Identical to Decentralized Corruption (Mahfud MD: Otonomi Daerah Identik Desentralisasi Korupsi)," *Republika Online* (16 June 2012), <http://www.republika.co.id/berita/nasional/umum/12/06/16/m5ppoy-mahfud-md-otonomi-daerah-identik-desentralisasi-korupsi>, accessed 2 December 2015.

in Lampung, Indonesia.<sup>32</sup>

Many spectacular cases of ‘money politics’ in elections for regional leaders, involving blatant vote buying and influence peddling, were revealed.<sup>33</sup> It did not stop there. Not long after the implementation of *desentralisasi* laws, regional governments introduced a wide array of taxes and charges, in many cases exceeding their legal authority in doing so.<sup>34</sup> Requests of ‘third party contributions’ – for example, contributions for street lightings even when the electricity is produced by the companies themselves—have become rampant and add new costs to businesses.<sup>35</sup> Other types of business distorting regulations including charges to obtain licenses for export/import, taxes and charges on specific commodities including fish, cattle, and plantation produce, charges to obtain certificates of origin, loading/unloading fees, road and transport charges, local import bans, etc.<sup>36</sup> Many of these taxes and charges are in breach of national laws.<sup>37</sup> This type of unclear policy runs counter to the main goal of *desentralisasi* in pushing further development in the region because as the costs increase, the capacity of enterprises to expand will be reduced. Even worse, the lack of clarity in regulations may actually drive away foreign investors from such regions.

According to the former Minister of Domestic Affairs, 330 regional government leaders (comprising approximately 86% of all the regional leaders) were involved in corruption probes.<sup>38</sup> The former president Susilo Bambang Yudhoyono viewed this as a negative result of regional autonomy.<sup>39</sup>

*Desentralisasi* also raises another problem. As regional governments are allocated with a budget, some of them have used such discretionary funds to invest in regional companies. However, several cases have demonstrated how some regional governments have attempted to prevent foreign investors from obtaining control of regional companies, thus leading to conflicts.

In *Cemex v Indonesia*,<sup>40</sup> the investor acquired shares in the State-controlled company PT Semen Gresik (PT SG) and held an option to buy a 51% stake by 2001. However, the investor could not exercise this option because of local opposition to a foreign takeover.<sup>41</sup> In fact, this case involved the issuance of statements by local

<sup>32</sup> Kevin McCoy, “Alstom Nears \$700M Settlement with US,” USA Today (17 December 2014), <http://www.usatoday.com/story/money/business/2014/12/17/alstom-foreign-bribery-settlement/20524399/>, accessed 2 September 2015.

<sup>33</sup> Vedi R Hadiz in Aspinnall and Fealy (eds), *op.cit.*, pp. 125-127.

<sup>34</sup> Aspinnall and Fealy, *op.cit.*, p. 6.

<sup>35</sup> Mohammad Sadli, “Regional Autonomy, Regulatory Reform, and the Business Climate” in Coen J G Holtzappel and Martin Ramstedt (eds), *Decentralization and Regional Autonomy in Indonesia: Implementation and Challenges* (Singapore: ISEAS, 2009), pp. 145-146.

<sup>36</sup> *Ibid.*, pp. 160-163.

<sup>37</sup> Aspinnall and Fealy, *op.cit.*, p. 6.

<sup>38</sup> “Minister Gamawan: 86 Percent of Regional Government Leaders are Corrupt (Menteri Gamawan: 86 Persen Kepala Daerah Korupsi),” Tempo.co (24 July 2014), <http://www.tempo.co/read/news/2014/07/24/078595388/Menteri-Gamawan-86-Persen-Kepala-Daerah-Korupsi>, accessed 2 December 2015.

<sup>39</sup> Rabby Pramudatama, “SBY Warns of Time Bomb in RI Mining,” Jakarta Post (8 August 2012), <http://www.thejakartapost.com/news/2012/08/08/sby-warns-time-bomb-ri-mining.html>, accessed 2 December 2015.

<sup>40</sup> *Cemex Asia Holdings Ltd v Republic of Indonesia*, ICSID Case No ARB/04/3, Parties’ Settlement Agreement (23 February 2007).

<sup>41</sup> “Indonesia in for Messy Cemex Litigation,” Jakarta Post (6 February 2004), <http://m.thejakartapost.com/news/2004/02/06/indonesia-messy-cemex-litigation.html>, accessed 2 December 2015.



citizens on behalf of West Sumatra regarding the future of one of Semen Gresik's subsidiary PT Semen Padang, including a potential spin-off of Semen Padang.<sup>42</sup> When the negotiations with the central government stalled, Cemex submitted the dispute to the International Centre for Settlement of Investment Disputes (ICSID) for breach of contract and *de-facto* expropriation under the 1987 Association of South-East Asian Nations (ASEAN) Agreement for the Promotion and Protection of Investments. However, the government and Cemex managed to settle the dispute by an agreement prior to the ICSID hearings.<sup>43</sup>

In *East Kalimantan v PT KPC*,<sup>44</sup> the regional government of East Kalimantan (GPEK) wanted to acquire the shares in PT Kaltim Prima Coal (KPC)—a coal mining company owned fully by private investors—based on the obligation to divest a certain amount of shares to a local investor as provided in the concession contract of the company. Eventually, a divestment was done, but instead of GPEK, other Indonesian entities and a foreign investor acquired the shares. GPEK brought this case to ICSID to enforce the divestment obligation based on the dispute settlement provision in the concession contract. The tribunal found that it lacked jurisdiction because the requirements under Article 25 of the Convention on the Settlement of Investment Disputes between States and Nationals of Other States<sup>45</sup> were not met. GPEK failed to show that it was designated as a constituent division of the Government of Indonesia for the purpose of the provision.<sup>46</sup> This was one of the few cases where a regional government acted as claimant against a foreign investor.

## B. Lack of Coordination and Capabilities

There is a lack of coordination between the central and regional governments and a lack of capable human resources in the regional governments.<sup>47</sup> Nasution suggests that the lack of coordination is caused by confusion of authority between the different levels of government.<sup>48</sup> This has also caused problems for foreign investors. For example, a regional government could refuse to approve an application of a license by a foreign investor without providing any reasons despite the fact that the investor had secured an in-principle approval from the central government.

In addition, the regional governments are constrained by the limited skills and capability of personnel. This is exacerbated by the influence of political considerations which made appointments to certain career positions in the civil service became non-transparent and arbitrary. There is clear preference for employees who are 'native' to the district of province, but may not have the required capabilities.<sup>49</sup> This hampers

<sup>42</sup> Minako Sakai, "The Privatisation of Padang Cement: Regional Identity and Economic Hegemony in the New Era of Decentralisation," in Aspinall and Fealy(eds), *op.cit.*, pp. 151-152.

<sup>43</sup> *Cemex Asia v Indonesia*, *op.cit.*

<sup>44</sup> Government of the Province of East Kalimantan v PT Kaltim Prima Coal, Rio Tinto Plc, BP Plc, Pacific Resources Investments Ltd, BP International Ltd, Sangatta Holdings Ltd, Kalimantan Coal Ltd, ICSID Case No ARB/07/03, Award on Jurisdiction (28 December 2009) (*East Kalimantan v PT KPC*).

<sup>45</sup> Convention on the Settlement of Investment Disputes Between States and Nationals of Other States, 18 March 1965 (entered into force 14 October 1966), 17 UST 1270, TIAS 6090, 575 UNTS 159 (ICSID Convention).

<sup>46</sup> *East Kalimantan v PT KPC*, *op.cit.*, paras 198, 200, 218.

<sup>47</sup> Bappenas, *op.cit.*, pp. IV-80 - IV-85.

<sup>48</sup> Nasution, *op.cit.*: 694.

<sup>49</sup> Arellando A Colongon Jr, "What is Happening on the Ground? The Progress of Decentralisation," in Holtzappel and Ramstedt, *op.cit.*, pp. 95-96.

the selection of civil servants based on their merits, and eventually affects their performance in delivering services effectively and efficiently.

Conflicting policies between the central and regional governments do not occur only in Indonesia, but also in many other federal countries around the world. In *Metalclad v Mexico*,<sup>50</sup> the investor relied on the representation of the Mexican federal government that no other permits were required for its operation. However, the regional government required municipal construction permits and refused to allow the operation of the investor's hazardous waste landfill.<sup>51</sup> The tribunal found this amounted to a violation of the obligation to provide fair and equitable treatment<sup>52</sup> and amounted to unlawful indirect expropriation.<sup>53</sup>

Indonesia faces similar claims in *Churchill Mining v Indonesia* and *Planet Mining v Indonesia*, after the decision of the regional government to revoke the licenses of the investors' partner companies.<sup>54</sup> Churchill Mining and Planet Mining (a wholly-owned subsidiary of Churchill Mining) brought their claims under two different BITs, the Indonesia-United Kingdom BIT and the Indonesia-Australia BIT. Both investors collectively invested in an Indonesian company, PT Indonesian Coal Development (PT ICD), with the purpose of conducting exploration and exploitation of coal in East Kutai, Indonesia.<sup>55</sup> Since PT ICD only had licenses for general mining and supporting services, it entered into various cooperation agreements, investors' agreements and 'pledge of shares' agreements with the Ridlatama Group, which had the exploration and exploitation licenses of the East Kutai Coal Project (EKCP).<sup>56</sup>

However, after the issuance of the licenses, the regional government claimed that some of the licenses overlapped with those of other license holders and were allegedly forged.<sup>57</sup> As such, the Regent of East Kutai decided to revoke the licenses of the Ridlatama Group.<sup>58</sup> While the Regent argued that the revocation of the licenses was in accordance with the recommendations given in a Letter of the Ministry of Energy and Mineral Resources, the Ministry argued that it never made such specific recommendations.<sup>59</sup> The relevant tribunals have decided that they have jurisdiction over the cases.<sup>60</sup> The cases are now pending on the merits. Both cases reflect the lack of coordination in license management. The case of overlapping licenses in Indonesia is not unusual.<sup>61</sup> In 2011 alone, 1,052 license holders reported overlapping claims. This happens partly because the regional governments often do not send the necessary reports to the central gover

<sup>50</sup> *Metalclad Corporation v Mexico*, ICSID Case No ARB(AF)/97/1, Award (30 August 2000).

<sup>51</sup> *Ibid.*, paragraphs 86–89.

<sup>52</sup> *Ibid.*, paragraphs 100–101.

<sup>53</sup> *Ibid.*, paragraphs 106–107.

<sup>54</sup> *Churchill Mining v Indonesia*, ICSID Case Nos ARB/12/14 and ARB/12/40, Decision on Jurisdiction (24 February 2014), paragraphs 35–37.

<sup>55</sup> *Ibid.*, para 16; *Planet Mining v Indonesia*, ICSID Case Nos ARB/12/14 and ARB/12/40, Decision on Jurisdiction (24 Feb 2014), paragraph 15.

<sup>56</sup> *Planet Mining v Indonesia*, *op.cit.*, paragraphs 22–28; *Churchill Mining v Indonesia*, *op.cit.*, paragraphs 22–28.

<sup>57</sup> *Ibid.*, paragraph 35.

<sup>58</sup> *Ibid.*, paragraph 36.

<sup>59</sup> *Churchill Mining v Indonesia*, *op.cit.*, paragraph 37.

<sup>60</sup> *Ibid.*, paragraphs 225, 229–230; *Planet Mining v Indonesia*, *op.cit.*, paragraph 215.

<sup>61</sup> Commission of Corruption Eradication of Indonesia, "Memorandum of Understanding and Collective Action Plan: Annex 1 on Harmonization of Policies and Regulations (Nota Kesepakatan dan Rencana Aksi Bersama: Lampiran 1 Harmonisasi Kebijakan dan Peraturan Perundangan)," <http://acch.kpk.go.id/documents/10157/34337/Lampiran+1+--+Nota+Kesepakatan+Bersama.pdf>, accessed 21 October 2014, 1–2.



Although this type of dispute can be resolved by the judiciary,<sup>62</sup> there have been concerns about the impartiality of the judiciary system. For example, there had been numerous cases of judges being bribed by the parties to disputes. The most recent case involved a renowned Indonesian lawyer who allegedly instructed his subordinate to bribe three judges of the Medan State Administrative Court in exchange for a favourable ruling for his client.<sup>63</sup> While the young subordinate was arrested right after handing over the bribe in the amount of approximately US\$30,000, the renowned lawyer maintained his innocence before the Jakarta Anti-Corruption Court. No final decision has been issued yet as of the time this paper is written.

### III. Alleviating the Problems of *Desentralisasi*

Some of the cases suggest that the *desentralisasi* system, initially only a domestic issue, may result in international disputes when it affects foreign investors. While some academics in Indonesia have suggested that it is not fair that the central government should be sued for the acts of its regional governments,<sup>64</sup> we do not think that this is the case. Under international law, the central government is always responsible for all actions of its regional governments. Article 4(1) of the ILC Articles, which codifies the customary rule,<sup>65</sup> provides that:

*The conduct of any State organ shall be considered an act of that State under international law, whether the organ exercises legislative, executive, judicial or any other functions, whatever position it holds in the organization of the State, and whatever its character as an organ of the central Government or of a territorial unit of the State.*<sup>66</sup>

Many BITs and IIAs also provide this explicitly, such as Article 4 of ACIA:

- (f) “measures” means any measure of a Member State, whether in the form of laws, regulations, rules, procedures, decisions, and administrative actions or practice, adopted or maintained by:
- i) central, **regional or local government** or authorities; or
  - ii) non-governmental bodies in the exercise of powers delegated by central, regional or local governments or authorities;<sup>67</sup>

<sup>62</sup> Indonesia (2), Undang-Undang tentang Kekuasaan Kehakiman (Law regarding Judicial Authority), UU No. 48 Tahun 2009, LN No. 157 Tahun 2009 (Law Number 48 Year 2009, SG No. 157 Year 2009) art. 20(2)(b); Indonesia (3), Peraturan Mahkamah Agung tentang Hak Uji Materiil (Regulation of the Supreme Court regarding the Right to Conduct Material Review) Perma No. 1 Tahun 2011 (Regulation of the Supreme Court No. 1 Year 2011).

<sup>63</sup> Erwin Sihombing, “In Graft Trial, Veteran Lawyer Kaligis Points Finger at Young Subordinate,” Jakarta Globe (31 August 2015) <http://jakartaglobe.beritasatu.com/news/graft-trial-veteran-lawyer-kaligis-points-finger-young-subordinate/>, accessed 2 December 2015.

<sup>64</sup> Hikmahanto Juwana, “Indonesia Should Withdraw from the ICSID,” Jakarta Post (2 April 2014) <http://www.thejakartapost.com/news/2014/04/02/indonesia-should-withdraw-icsid.html>, accessed 2 December 2015.

<sup>65</sup> Estate of Hyacinthe Pellat (France) v United Mexican States, Decision No 34 (7 June 1929) 5 RIAA 534, 536; LaGrand (Germany v United States of America) (Provisional Measures) [1999] ICJ Rep 9, para 16; James Crawford, State Responsibility: The General Part (Cambridge: Cambridge University Press, 2013), p. 123.

<sup>66</sup> International Law Commission, Articles on Responsibility of States for Internationally Wrongful Acts, UN GAOR 53rd Session Supp No 10, UN Doc A/56/83 (2001) art 4(1) (emphasis added).

<sup>67</sup> ASEAN Comprehensive Investment Agreement, 26 February 2009 (entered into force 29 March

## A. Improving the Existing IIAs

It is for the central government or even the parliament to take action—for example, by implementing a new mechanism—to ensure that the *desentralisasi* system will function better. The mechanism should also ensure better coordination between the central and regional governments. Indonesia could also include a clause in its model IIA to ensure that in certain sectors, such as mining, forestry, or oil and gas, all the relevant authorities are kept informed. The clause could state as follows:

In order to be protected under this agreement, investments in the sectors of [mining, forestry, or oil and gas] need to be approved by both the central and the relevant regional government pursuant to the prevailing law in Indonesia. The relevant approving institutions in each Member State are provided in the Annex to this agreement.

This type of a clause ensures that both the government—central and regional—and foreign investors are on the same page. With this mechanism, foreign investors have to inform both the central and the relevant regional government about their presence in a particular region. Thus, the regional governments can no longer argue that they have no international obligations to protect the foreign investors, and the central government will have more control of the licensing process.

In fact, presumably as a reaction to the previous cases where *desentralisasi* led to claims by investors, Parliament amended the Law on Regional Governments on 2 October 2014 with Law No. 23 of 2014. In the new law, Parliament removed the authority of the regency and municipal administrations to issue mining-related licenses.<sup>68</sup> It has been reported that the main reason to remove their authority to issue licenses was that the regency and municipal administrations have been found to issue permits to certain firms for personal gain, and so far these administrations have issued as many as 8,800 mining permits since 2009.<sup>69</sup> The new law is expected to help the central government in managing the mining sector, one of the main contributors to the State income, better. Although this can be a new step to streamline permit procedures and prevent abuses due to *desentralisasi*, Parliament still needs to take action to resolve any conflict between the new law and the 2009 Mining Law, which was enacted based on the principles of regional autonomy and decentralization. It may be that a regional government may also decide to challenge the law before the Constitutional Court as being contrary to the principle of *desentralisasi* found in the Indonesian Constitution. At the same time, the new law does not resolve all problems of *desentralisasi* as the provincial governments (as opposed to regency and municipal administrations) continue to have the authority to issue permits without coordinating with the central government.

## C. Innovative Dispute Prevention Mechanism

Realizing that regional governments may issue measures that can be the subject

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2012), art 4(f) (emphasis added); see also Investment Chapter of the ASEAN-Australia and New Zealand Free Trade Agreement (AANZFTA), art 2(h).

<sup>68</sup> Indonesia (4), Undang-Undang tentang Pemerintahan Daerah (Law regarding Regional Governance), UU No. 23 Tahun 2014, LN No. 244 Year 2014 (Law Number 23 Year 2014, SG No. 244 Year 2014), annex, sub-part on division of authority in energy and mineral resources.

<sup>69</sup> Raras Cahyafitri, "New Law Scraps Local Govts' Power in Mining," Jakarta Post (6 October 2014) <http://www.thejakartapost.com/news/2014/10/06/new-law-scraps-local-govts-power-mining.html>, accessed 26 March 2015.

of disputes with foreign investors under Indonesia's IIAs, it is important to create a proper mechanism to prevent such disputes from being brought to ISDS. Peru and South Korea have installed such dispute prevention mechanisms.

In Peru, the government recognizes the importance of anticipating the sources of problems and take preventive action, rather than acting only after an incident arises and damage has been caused.<sup>70</sup> For this reason, Peru created the State Coordination and Response System for International Investment Disputes (Response System). The system is established under Law No. 28933 (December 2006) and regulated further under Supreme Decrees. The System requires all government agencies involved in an investment dispute to cooperate and provide all information, thereby creating accountability at all levels of government for measures or policies which are inconsistent with Peru's IIAs.<sup>71</sup>

Similar to Indonesia, Peru also has regional governments as well as decentralised public entities and enterprises. All of these parts of the government are included in the Response System.<sup>72</sup> With a diverse set of legal instruments containing investment commitments that can trigger international arbitration, it is important to ensure that the government is aware of such commitments. Therefore, the Response System requires any agency that enters into an agreement that provides for ISDS to report that agreement electronically to the Response System Coordinator. Thus, the country can have a consolidated central database containing all of its investment commitments that can be accessed by all relevant agencies.<sup>73</sup> With this, all agencies can consult to the database and analyse whether a particular policy can lead to violation of the country's investment commitments. Similarly, Indonesia has more than 60 IIAs and numerous concession agreements with foreign investors that contain ISDS clauses. With a variety of different provisions, to understand all different commitments made by Indonesia is very complex.<sup>74</sup> The establishment of such a central database must be coupled with proper training of government officials on how to use it. The tool should be designed in such a way as to allow both the central and regional level officials to consult the different investment related commitments that the government has as they develop policies and regulations affecting foreign investors, as well as when they enter into obligations with investors.<sup>75</sup>

The System aims to provide optimal responses to investment problems and disputes susceptible to international arbitration. This is to ensure that a problem at an early stage already receives timely and appropriate attention, thus negotiations can be conducted to find amicable settlements rather than resorting to international arbitration.<sup>76</sup> For this purpose, an early alert mechanism is critical. Every agency at all levels of government must promptly report electronically to the Response System Coordinator any investment disagreement or problem that may be subject to ISDS. The System also allows foreign investors to directly contact the Special Coordinator

<sup>70</sup> UNCTAD, Best Practices in Investment for Development – How to prevent and manage investor-State disputes: Lessons from Peru, Investment Advisory Series B No 10 (Geneva: United Nations, 2011), p. 42.

<sup>71</sup> *Ibid.*, p. 21.

<sup>72</sup> *Ibid.*, p. 22.

<sup>73</sup> *Ibid.*, p. 29.

<sup>74</sup> It is important to conduct a proper study of the various commitments in the instruments. For example see: Junianto James Losari, "Comprehensive or BIT by BIT: The ACIA and Indonesia's BITs," Asian Journal of International Law (2015) <http://journals.cambridge.org/action/displayAbstract?fromPage=online&aid=9537764&fileId=S2044251314000332>, accessed 2 December 2015.

<sup>75</sup> UNCTAD, *op.cit.*, p. 37.

<sup>76</sup> *Ibid.*, p. 29.

(SC), thus allowing the Coordinator to be more responsive.

If the investor still refuses to settle the dispute amicably and decides to submit the dispute to ISDS, the System provides specific procedures for optimal coordination within all government agencies with the SC acting as the contact point. All involved agencies and public servants must provide all relevant information to the case and empower the SC to lead the process.<sup>77</sup> The System also empowers the SC to impose the costs of the arbitration process and of any award against the State on the agency that has triggered the dispute.<sup>78</sup> In the context of Indonesia, this could mean imposing the costs as an option on the budget of the relevant regional government that triggers a dispute, thus holding it accountable for its decisions that may be contrary to Indonesia's commitments in its IIAs. This can be a lesson and a way to incentivise other regional governments to carefully analyse proposed measures that may affect foreign investors before implementing them.

An institutionalised dispute prevention mechanism can be seen in South Korea's Office of Foreign Investment Ombudsman, an independent body that handle grievances by foreign investors through prompt aftercare services.<sup>79</sup> The office has the legal authority to request from related agencies data, materials, and other information deemed relevant and vital to the resolution of foreign investor grievances.<sup>80</sup>

The office creates the Home Doctor System that resolves problems reported by foreign investors, not only directly by sending licensed and experienced exports to business sites, but also by taking pre-emptive measures to prevent future problems by encouraging systemic improvements and legal amendments.<sup>81</sup> During 1999-2007, 334 cases out of 625 cases were successfully resolved through administrative intervention. In addition, 221 cases were handled internally by home doctors.<sup>82</sup> Over the years, the home doctors have gained rich experience and vast knowledge in resolving many of the grievances submitted. They played a key role in the process.<sup>83</sup>

We are not suggesting that Indonesia should copy South Korea and Peru's models. Rather, these models can inspire Indonesia to innovate a new dispute prevention mechanism model that suits to the unique context of Indonesia, a model that takes into account *desentralisasi* in its formulation while ensuring early warnings are provided, sufficient transparency is given and all the relevant stakeholders are involved in the management of the dispute.

#### IV. Conclusion

The potential of Indonesia to be one of the top ten economies in the world is undisputed. Christine Lagarde, Managing Director of the International Monetary Fund (IMF), explained that Indonesia's reservoir of young people should be harnessed as a

<sup>77</sup> *Ibid.*, p. 30.

<sup>78</sup> *Ibid.*, p. 31.

<sup>79</sup> Office of the Foreign Investment Ombudsman, "Overview and Mission" <http://www.i-ombudsman.or.kr/eng/au/index.jsp?num=3>, accessed 2 December 2015.

<sup>80</sup> Françoise Nicolas, Stephen Thomsen and Mi-Hyun Bang, "Lessons from Investment Policy Reform in Korea," OECD Working Papers on International Investment 2013/02 (2013).

<sup>81</sup> Choong Yong Ahn, "New Direction of Korea's Foreign Direct Investment Policy In The Multi-Track FTA Era: Inducement and Aftercare Services" OECD Global Forum on International Investment (27-28 March 2008), <http://www.oecd.org/investment/globalforum/40400795.pdf>, p. 12.

<sup>82</sup> *Ibid.*

<sup>83</sup> *Ibid.*, p. 13.

growth propeller.<sup>84</sup> Nevertheless, all this will only come into reality only if Indonesia can develop its infrastructure, investment and trade. We have highlighted that soft infrastructure, such as bureaucracy and coordination are as essential as physical infrastructure. Without such proper soft infrastructure, the development of the physical infrastructure may be derailed.

In particular, we have explored how the problems arising from *desentralisasi* does not create a conducive investment climate in Indonesia. We note that there have been internal efforts by the central government and the parliament to discipline the system. However, in light of the existing IIAs that can also lead Indonesia to ISDS cases because of the regional governments' policies and measures, we suggest several things to be done.

First, Indonesia should continue maintaining these IIAs as it can also contribute to the enforcement of regulatory discipline and encourage the regional governments to act in accordance with the rule of law.

Second, Indonesia's future IIAs should include provisions that can hold the regional governments accountable for its actions. One of them is making them aware that they also have obligations towards foreign investors in their regions.

Third, rather than dealing with investment disputes in international arbitration, the government should prevent these disputes from being brought to ISDS by creating a dispute prevention mechanism. Several models (South Korea and Peru) can be useful inputs for the government in designing its own model that can suit Indonesia's context.

We believe that by improving its soft infrastructure, including the *desentralisasi* system, Indonesia can become a more attractive destination for FDI due to better rule of law and governance. These eventually can put Indonesia back on track in its pursuit of sustainable economic development and better lives for Indonesians.

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<sup>84</sup> Christine Lagarde, "Poised for Take-Off-Unleashing Indonesia's Economic Potential," Jakarta (1 September 2015), <http://www.imf.org/external/np/speeches/2015/090115.htm>, accessed 2 December 2015.

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