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**Research Report**

## Friends or foes? Interactions between Indonesia's international investment agreements and national investment law

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## Studies

# Friends or Foes? Interactions between Indonesia's International Investment Agreements and National Investment Law

*Jan Knörich*  
*Axel Berger*

Friends or foes? Interactions between  
Indonesia's international investment agreements  
and national investment law

**The German Development Institute / Deutsches Institut für Entwicklungspolitik (DIE)** is a multidisciplinary research, policy advice and training institute for Germany's bilateral and multilateral development cooperation. On the basis of independent research, it acts as consultant to public institutions in Germany and abroad on current issues of cooperation between developed and developing countries. Through its nine-month training course, the German Development Institute prepares German and European university graduates for careers in the field of development policy.

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Bonn and London, April 2014

Axel Berger and Jan Knörich





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## Abbreviations

AANZFTA	ASEAN-Australia-New Zealand Free Trade Area
ACIA	ASEAN Comprehensive Investment Agreement
AIA	ASEAN Investment Area
APEC	Asia-Pacific Economic Cooperation
ASEAN	Association of Southeast Asian Nations
BANI	Indonesia National Board of Arbitration
BIT	Bilateral Investment Treaty
BKPM	Indonesian Investment Coordinating Board
CSR	Corporate Social Responsibility
DDI	Domestic Direct Investment
EPA	Economic Partnership Agreement
EUROCHAM	European Chamber of Commerce
FDI	Foreign Direct Investment
FET	Fair and Equitable Treatment
FPS	Full Protection and Security
FTA	Free Trade Agreement
GDP	Gross Domestic Product
ICSID	International Centre for Settlement of Investment Disputes
IIA	International Investment Agreement
IMF	International Monetary Fund
IPA	Investment Promotion Agency
ISDS	Investor-State Dispute Settlement
KPPU	Commission for the Supervision of Business Competition
MFN	Most-Favoured Nation
MNE	Multinational Enterprise

MP3EI	Masterplan for Acceleration and Expansion of Indonesia Economic Development 2011–2025
NAFTA	North American Free Trade Agreement
OECD	Organisation for Economic Co-operation and Development
POLRI	Indonesian National Police
PPP	Public-Private Partnership
PTIA	Preferential Trade and Investment Agreement
PTSP	One-stop Integrated Service
RPJMN	National Medium-term Development Plan
RPJPM	National Long-term Development Plan
SME	Small and Medium-sized Enterprise
SOE	State-owned Enterprise
TIFA	Trade and Investment Framework Agreement
TNI	Indonesian National Military
TRIMs	Agreement on Trade-Related Investment Measures
TRIPS	Trade-Related Aspects of Intellectual Property Rights
UNCTAD	United Nations Conference on Trade and Development
WTO	World Trade Organization

## Executive summary

By signing international investment agreements (IIAs), developing countries commit themselves to international rules that provide foreign investors with far-reaching legal protection and also, increasingly, free market access. The investor-state dispute settlement (ISDS) provision, which is a standard feature of most IIAs, puts pressure on states to comply with these internationally agreed-upon rules, or else they face the threat of being sued for compensation in costly international arbitration procedures. The number of such ISDS cases has risen sharply during the past 15 years and it is beginning to have serious repercussions for host countries and the international investment regime in general.

ISDS cases usually originate from a mismatch between a law or measure adopted at the national level and one or several relevant commitments made in an IIA. When concluding IIAs, host countries should therefore have an interest to ensure conformity between national laws and measures on the one hand, and commitments in IIAs on the other hand. This represents a major challenge, given the more than 3,000 treaties that have been negotiated globally to date and the complexities of the laws and legal systems involved. Nevertheless, despite these significant challenges and the magnitude of possible consequences from not properly handling the interaction between national laws and measures and international investment law, the literature on investment law and policy has paid surprisingly little attention to the question of how these two areas of the law meet and interact.

To fill this vacuum in the field of investment law and policy, **this study examines how elements of IIAs are reflected and replicated in domestic laws and regulations governing foreign investment.** Whereas previous studies tended to focus on either international or national investment law, this study's contribution is to analyse both of them in parallel. In order to effectively accomplish this task, this study introduces a **novel and unique pattern-matching technique** that can be used to effectively examine the interaction between IIAs and national investment laws of a particular country. This technique is applied to the specific case of Indonesia through an in-depth examination of Indonesian investment law and policy at the international and national levels. To the knowledge

of the authors, this study is the first to provide focused empirical evidence on these issues by way of a detailed juxtaposition of a specific country's national and international investment laws.

## Innovative method

The study is conducted in four distinct steps: the mapping of all IIAs signed by Indonesia; their comparison with Indonesia's national laws; an examination of individual and controversial measures in greater detail; and consideration of inter-ministerial coordination and stakeholder consultations related to investment issues. The value of this methodology is that it is quite holistic in examining investment law and policy, and it can provide insights on issues such as: consistency between domestic laws and regulations and international commitments; potential risks of inconsistencies; and implications for national policy space and economic development. The methodological approach used within this study is also quite straightforward and can be easily replicated for examinations of other countries and contexts.

## The Indonesian case

This study applies a single-country case study design focusing on Indonesia's investment law and policy. The Indonesian case is representative of a larger class of countries, as it has attracted substantial investment flows, signed a large number of IIAs over a long period of time and has been involved in a number of ISDS cases.

The study on the interaction of Indonesia's IIAs and its national investment law focuses on four inter-related aspects.

### *Complex interactions between national investment law and IIAs*

First and foremost, the nature of the interaction between Indonesia's international investment law and national laws and measures is analysed for the purpose of developing an appropriate analytical framework. In domestic laws, this includes detailed examinations of laws governing investment matters directly (investment-specific laws) as well as laws



in other areas that have an impact on investments (investment-related laws). The initial finding is that **the interaction between international and domestic laws is an extremely complex affair, as both differ significantly in structure and content**. IIAs have the character of a network of treaties and a long-term dimension, whereas a domestic legal framework consists of a myriad of very different legal texts, including the Constitution, financial regulations, competition law, trade law, labour and human rights laws etc., and can be subject to regular revisions and amendments.

The challenge is to bring this variety of laws and legal regulations in conformity with each other and ensure formal consistency and coherence. This study's in-depth examination of the interaction between international commitments and national law has shown that both are coherent in many respects, although several areas of divergence were also detected. The extent to which this divergence between international commitments and national laws is serious and could lead to investor-state disputes is hard to predict, but it is safe to argue that a certain degree of incoherence is unavoidable, and in many instances this is unlikely to cause harm.

**Indonesia's choice to have an "interlocking law" that functions as an interface between international commitments and national law is a promising way to face the challenge of complexity**. This law is structured along the lines of IIAs, while attempting to combine the relevant issues of a large set of national laws into one legal text. The interlocking law, originally enacted in the late 1960s, has been revised once, in 2007, creating Law No. 25/2007 concerning Investment. Although the overall system of national and international investment law remains very complicated, it could be argued that the interlocking law is effective in dealing with complexity, to some extent helping achieve consistency between international commitments and domestic investment laws. At the same time, the interlocking law functions as an intermediary where national and international laws "meet". It reflects compromises that have been reached and is indicative of areas where policy space has been negotiated.

In addition, **Indonesian IIAs include frequent references to Indonesian domestic laws and regulations**, which could be an additional hedging strategy to deal with the uncertainties of complexity. Indonesia includes a standard provision in most of its BITs that refers to its domestic

interlocking law to establish applicability of the agreement. It is difficult to judge the legal significance of such references to domestic laws and regulations, but it is clearly a strategy to hedge against risks and to elevate the standing of Indonesian national laws whilst taking on international commitments.

#### *Primacy of international investment law?*

The second aspect of concern in this study is the direction of the interaction. Should national investment law form the basis for international commitments made in IIAs or *vice versa*? This study found evidence that **the interaction between Indonesia's international commitments on investment and its national laws in this area is bi-directional**. Even though international rules are likely to have somewhat more clout in Indonesian national policy than the other way round, the fact that Indonesia is not a mere “price-taker” of international rules is noteworthy, as developing countries over the past decades often adopted IIAs without sufficiently considering their national legal systems for investment.

#### *How to manage complex interactions?*

The third aspect explored in this study is the governance mechanisms employed to ensure the consistency of government actions pertaining to foreign investments with international commitments. Serious coordination problems have been found to exist in some developing countries with regard to the ability of governments to adopt national legislation that is in accordance with their international commitments. It is not uncommon to have IIAs negotiated by a small group of specialists within single government branches, keeping other central or local-level government agencies, as well as various interest groups and stakeholders, out of the picture. This practice most likely elevates the possibility of policy mal-coordination and, by extension, the occurrence of ISDS cases.

This study finds that involving these groups in the policy process of ensuring consistency between international commitments and national investment law is a useful exercise. To advance appropriate governance of investment matters, Indonesia has introduced procedures of **inter-ministerial coordination** and **stakeholder consultations** into the

process of rule-making on investment. Despite existing controversies over the effectiveness and impact of this process in Indonesia and elsewhere, the involvement of a variety of stakeholders on issues of investment law is probably an important and useful activity as part of the rule-making process, especially as it might help identify, at an early stage, potential areas where new measures could potentially trigger the emergence of ISDS cases.

Combined with the process of negotiating IIAs with other national governments, such inter-ministerial coordination and stakeholder consultations form a “**Bargaining Triad**” of three distinct groups of actors that compete and collaborate in the process of forming investment law and policy. Such bargaining among potentially inconsistent inter-governmental, inter-ministerial and stakeholder interests parallels the inconsistency in formal laws, rules and regulations. The power structure and inter-relationships within the Bargaining Triad are an important determinant of the nature and interaction of international and national laws and regulations. A government can manage these inter-relationships, for example by identifying a specified agency responsible for handling negotiations among these different sets of interests.

#### *Implications for policy space*

Furthermore, this study examines the implications of all this for national policy space and economic development. Policy space is considered, within this study, as the ability of a government to pursue public policy objectives that follow a clearly formulated development strategy. Quite often, such objectives are best advanced through the full commitment and adherence to standard practices in international law. But the idea of policy space implies that conscious divergence from such practices – in view of specific national contexts of economic development – may at times be justifiable. The conclusion of IIAs expands a country’s international commitments and can, in turn, limit a government’s policy space. In the specific case of Indonesia, some scope for the state to manoeuvre and make use of its right to regulate was discernible. It appears that the **older IIAs limit policy space more significantly than recently negotiated IIAs**. Older IIAs are vaguely drafted, and thus provide much discretion for international arbitration tribunals to favour the interests of foreign investors. More

recent IIAs feature a more balanced approach that incorporates a large variety of clarifications and limitations, which potentially enhance the regulatory flexibility of the governments concluding the treaty.

The actual utilisation of policy space, however, occurs within the realm of domestic investment-specific or -related laws and regulations, and especially the relevant implementing measures, which are often responsible for triggering ISDS cases. **Policy space becomes a reality not through the mere existence of laws and regulations that seek to make use of available policy space, but through the possibility to implement and enforce these laws and regulations.** This difference becomes apparent in the Indonesian case, where many development considerations are featured strongly in domestic law, but are practically absent from Indonesia's IIAs. The dilemma, then, is that international commitments can restrict implementation and enforcement of national laws in practice, especially where the national law is more restrictive than the international commitments made. This study also suggests that policy space is more widely available with regard to facilitating measures.

Finally, a **transparent and consistent approach to national legislation may be as important as the issue of consistency with international commitments.** If policy space is not there, both the laws and the implementing regulations should reflect this. The state can draw on inter-ministerial coordination and stakeholder consultations to better determine how far it can go with any new measure, thereby achieving greater certainty about the kind of measures that still lie within the available policy space. This will allow the state to adapt new measures as optimally as possible to its development needs, whilst taking potential consequences into account, such as the emergence of investor-state disputes. Engaging with all members of the Bargaining Triad can help avoid readjustments and amendments to laws and regulations having to be made at a later stage. Governments should make sure that measures are implemented after they have been fully developed and the consequences and feasibility sufficiently examined, in order to avoid any backtracking that could reduce transparency and even lead to investor-state disputes. In other words, it is important to develop measures with due care and involving substantial amounts of time, with governments – as the ultimate decision-makers – always having the final say about a measure.

## 1 Introduction

Over the past half-century, developing countries have been signing bilateral investment treaties (BITs) and preferential trade and investment agreements (PTIAs) in great numbers. Their main objective in signing such international investment agreements (IIAs)<sup>1</sup> has been to attract foreign investments by providing multinational enterprises (MNEs) with attractive and stable investment frameworks. By signing IIAs, developing countries commit themselves to international rules that provide foreign investors with far-reaching legal protection and also, increasingly, free market access. The investor-state dispute settlement (ISDS) provision, which is a standard feature of most IIAs, puts pressure on states to comply with these internationally agreed-upon rules. Under such clauses, foreign investors have the possibility to sue governments for compensation in costly international arbitration procedures in cases of non-compliance with the agreed treaty provisions. ISDS cases have risen sharply during the past 15 years and are primarily affecting governments of developing countries. Because the ISDS clause is being invoked by foreign investors with increased frequency, IIAs are beginning to have serious repercussions for developing countries and their governments, calling into question the net value to a developing country of concluding IIAs.<sup>2</sup>

ISDS cases usually originate from a mismatch between a law or measure at the national level and one or several relevant commitments made in an IIA.<sup>3</sup> When concluding IIAs, host countries therefore have to ensure conformity between national laws and measures on the one hand, and commitments in IIAs on the other hand. Given the multitude of negotiated treaties (more than 3,000 globally) and the complexities of national laws and regulations,

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1 Throughout the text, we use the term IIA to refer to the overall group of bilateral and plurilateral treaties, BITs and PTIAs that establish rules for the protection, promotion and liberalisation of FDI. We use the terms BITs and PTIAs to address questions relating specifically to these treaties.

2 According to UNCTAD (2013b), 58 ISDS cases were initiated in 2012, which is the highest number of new cases filed within one year. The total number of known cases reached 514 at the end of 2012, of which 244 have been concluded.

3 ISDS cases may also result from specific contracts between states and foreign investors that are enforceable through the so-called umbrella clause found in most IIAs. As this study is concerned with investment treaties, examination of such contracts will not form part of it.

ensuring such conformity is a major challenge that some developing countries are better able to handle than others.

Despite these significant challenges and the magnitude of possible consequences from not properly handling the interaction between national laws and measures and international investment law, the literature on investment law and policy is surprisingly silent on this issue. There are no “good practice” accounts on how best to manage the interactions between international and national investment law to minimise the risk of being sued by foreign investors. Instead, the literature is divided into two camps: one that has thoroughly examined international law on foreign direct investment and the global network of IIAs through a large number of studies; and the other focusing on national investment laws and regulations, in particular through the preparation of investment policy reviews. Accounts on how these two areas of the law meet and interact are rare.

The gap in the literature may also result from the fact that the interaction between international commitments and national laws is often insufficiently considered by governments in the process of negotiating IIAs. Poulsen (2014) shows that IIA policy-making in developing countries has hardly followed a rational approach, and policy-makers in these countries have insufficiently considered the risks involved when signing thousands of IIAs. As a result of ISDS cases brought against them, more and more governments of developing countries have now realised that they signed up to an especially constraining set of international rules that are enforceable through independent, third-party arbitration mechanisms (Poulsen / Aisbett 2013). Two assumptions about the relationship between national laws and IIAs follow from Poulsen and Aisbett’s findings and from the rapid surge in international arbitration cases globally: IIAs have not necessarily been concluded on the basis of existing national laws, and the international commitments most developing countries have signed up to through IIAs have not sufficiently been translated into national laws and regulations.

On the basis of these initial considerations, the primary objective of this study is to examine the interactions between national and international investment laws and appropriate governance mechanisms that governments of developing countries can employ to minimise inconsistencies between the two bodies of law. To our knowledge, this study is the first to provide detailed empirical evidence on these questions. We employ an innovative pattern-matching technique and work within the context of a single-

country case study design that allows intensive research of such a complex phenomenon. As we explain below, Indonesia's investment policy offers a good case in this respect. Referring to the Indonesian experience, the study examines the following research questions:

*1 How do international investment law and national laws and measures interact and how can those interactions be framed analytically?*

In principle, international commitments and national legal systems should be coherently drafted, and it is quite intuitive to argue that national law should reflect international law and *vice versa*. However, international and national laws on foreign investment differ significantly in structure and content. International investment law has the character of a network in which each country signs a diverse set of treaties with its partner countries. Investment treaties tend to be short in content, focusing on international commitments in specific areas. Quite different from this, national investment laws consist of one or several investment-specific laws that deal explicitly with investment issues, plus an array of investment-related laws that regulate all kinds of issues, such as trade, industry, monetary and fiscal policy, labour, energy, environment, human rights and many more. In each investment-related law, there is at least one clause that addresses investment matters. Although investment-specific laws are more easily kept in conformity with international commitments because both focus on the regulation of investment, the challenge of conformity is much greater for investment-related laws that cover a much more diverse set of issues. It is thus important to know how international and national laws on investment interact in practice and how a link between these two bodies of law can be effectively achieved by governments of developing countries, in a way that also minimises the likelihood of ISDS cases.

*2 To what extent does national investment law form the basis for international commitments made in IIAs?*

As with every other international institution or regime, IIAs constrain the ability of the contracting parties to adopt certain policy measures. The disciplines included in IIAs are sometimes considered – rightly or wrongly – to provide a more stable and favourable legal framework for foreign investors than national laws. Adopting international commitments into national law is considered to be a prudent approach if it improves the structure and content of national laws, enhances the domestic investment

climate and generally has a positive economic and development impact on the host economy. Hence, developing countries might find it necessary to revise national laws to reflect commitments made at the international level. In principle, a host state's national law should provide at least the level of legal protection for foreign investors that is stated in the IIAs it has signed, and some far-reaching commitments made in IIAs could necessitate significant adjustments in national investment law. However, from the perspective of a host country, the commitments being negotiated in the context of IIAs should reflect the specific set of investment-specific as well as investment-related policies that are envisaged as being instrumental and necessary to support the country's broader development strategy. Because national laws usually play a larger role from a host country's perspective, it is plausible to argue that they should form the basis for the international negotiations of IIAs. The question of whether national investment law forms the basis for international commitments made in IIAs, or whether the reverse effect is the case, is crucial for economic policy-making in developing countries.

### *3 What governance mechanisms should be in place to ensure conformity of national and international investment laws?*

Foreign investment has a profound impact on a variety of economic activities in a host country. A number of disciplines of IIAs have a deep impact on national laws and might require alterations in areas that are much less related to investment, such as labour laws, the environment and human rights. Furthermore, changes in these public policy areas may result in a breach of IIA provisions, thus triggering ISDS cases. As a result, a wide range of stakeholders play a role in managing the above-mentioned interactions, including political entities at the central and local levels of government, business interest groups and civil society stakeholders in the countries concerned. It is thus important to identify whether and how these groups should be involved in the policy process of ensuring consistency between international commitments and national investment law.

Serious coordination problems have been found to exist in some developing countries with regard to the ability of governments to adopt national legislation that is in accordance with their international commitments. It is not uncommon to have IIAs negotiated by a small group of specialists within individual government branches – usually economic or foreign affairs ministries – while other government agencies involved with the day-to-day regulation of foreign investments are neither made sufficiently aware



of the countries' international commitments, nor are they consulted in the process of negotiating these commitments. Such a lack of appreciation of a broad range of government agencies on the national and sub-national levels elevates the risk for developing countries of being sued by foreign investors for not abiding by the set of rules found in IIAs.

We are interested in appropriate governance mechanisms that can be employed by host countries to ensure the consistency of government actions pertaining to foreign investments and international commitments. This latter issue is of particular importance because a large variety of behind-the-border regulations, involving a number of government actors on the national as well as sub-national levels, can have a significant impact on foreign investment. Introducing efficient institutional frameworks of coordination and consultation among different sets of laws and regulations and various actors is a paramount governance challenge. We are thus also interested in the measures that developing countries can employ to avoid liabilities as a result of a mismatch of national and international rules.

#### *4 What are the implications of IIA disciplines for national policy space and economic development?*

If IIAs have a stronger impact on national law than *vice versa*, they might impose extensive constraints on the host country's policy space. Assuming that a developing country's national law reflects its broader development objectives, the IIAs it has negotiated should correspond with these goals. In short, drafting international and national investment law in a coherent way is not only important to avoid ISDS claims; more importantly, it is a prerequisite for host countries to use foreign direct investment (FDI) as a driver of economic development. This study thus contributes to the ongoing discussion of the effects of international economic treaties on developing countries' policy space.

By analysing the Indonesian case, we develop an understanding of what our findings mean for developing countries' policy space in the area of investment. By "tying themselves to the mast", developing countries voluntarily relinquish some of their flexibility in devising policies and regulations that aim to support structural change towards higher value added economic activities. In other words, the conclusion of IIAs expands a country's international commitments and, in turn, limits the government's policy space. We analyse which IIA provisions are more effective in this

respect. A growing strand of research on economic development has emphasised the importance of policy space in the development context, arguing that developing countries need some flexibility to advance economic policy in support of their specific national economic development objectives. On a general level, we share this understanding; however, we also realise that there are abundant examples where policy space has been used to implement ineffective, or even detrimental, industrial policies. Assessments of the need for policy space and the effectiveness of industrial policies are inevitably context-specific. What we aim at in this study is to show which IIA provisions have a constraining effect on a host country's policy space. We do not focus on the question to what extent – and in what way – this policy space should be used to promote a specific industrial policy in Indonesia. Governments of countries undergoing complex processes of economic transformation and development sometimes require the additional manoeuvrability in economic policy-making that is granted to them through policy space. In other circumstances, however, giving up policy space by pledging adherence to the norms of an international rules-based regime might be a preferable approach in view of a country's development objectives.

This study is of relevance for researchers as well as policy-makers in developing countries and international organisations. For researchers, this study introduces an innovative and replicable methodological approach to examine the interaction between IIAs and domestic investment law. For policy-makers in developing countries, this study offers insights into good practices as well as challenges to ensure formal and practical consistency between international commitments and national laws and regulations. Its particular contribution can be found in the juxtaposition of national investment policy with international commitments. Such a juxtaposition fills an important gap in the literature on international investment law, which tends to focus either on IIAs or domestic policy. The results of this study, furthermore, provide findings that can be useful for international organisations such as the United Nations Conference on Trade and Development (UNCTAD) or the Organisation for Economic Co-operation and Development (OECD) that regularly analyse the investment policy framework of developing countries but rarely deal systematically with the potential inconsistencies between national and international investment laws.

## 1.1 Case selection

Given the lack of previous research on the consistency of host countries' national and international investment policy-making, we employ a single-country case study design. Within-case analysis is especially useful for intense research of the complexities of one particular unit with the aim of producing findings that are generalisable for a larger class of cases (e.g. Gerring 2007, 20). To produce findings that are generalisable, it is important to choose a case that is representative of a larger class of countries. In the context of the present research design, the country under research should have: (1) signed a larger number of IIAs over a longer period of time as most developing countries have done, (2) experienced a number of ISDS cases and (3) attracted substantial investment flows in order to ensure the relevance of IIAs to economic policy-making.

Indonesia represents an interesting case in this respect. Indonesia attaches great importance to FDI to spur economic development and is in an ongoing process of expanding its IIA network. Indonesia has a long history of negotiating IIAs, which dates back to the 1960s, and has signed more than 50 IIAs on a bilateral and regional level. As with other developing countries, Indonesia signed BITs during the 1990s in great numbers and has started to shift its policy focus in recent years towards PTIAs that are negotiated on a regional level in the context of the Association of Southeast Asian Nations (ASEAN). The Indonesian strategy of negotiating IIAs thus reflects the experience of many other developing countries.<sup>4</sup> In the early days of its IIA negotiations, it followed a rather cautious IIA strategy. Specifically, since the 1970s, Indonesia has followed an IIA policy that includes safeguards allowing for the adoption of certain regulatory measures such as exceptions to the obligatory national treatment clause. In the 1990s, Indonesian IIAs have become more liberal by including, among other things, national treatment and market-access provisions. Indonesia is also a representative for the larger sample of developing countries, as it is experiencing ISDS arbitration

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4 Yackee (2008) shows that IIAs until the late 1980s did not entail ISDS provisions. Only in the 1990s did ISDS provisions become a standard feature of global IIA practice. China's IIA approach is a case in point: China negotiated IIAs without comprehensive ISDS provisions in the 1980s and 1990s before it switched to an IIA approach that not only provided foreign investors with the right to sue host countries, but also entailed national treatment provisions (Cai 2006; Gallagher / Shan 2009; Berger 2011).

cases brought against it by international investors at the International Centre for Settlement of Investment Disputes (ICSID).

FDI plays a crucial role for Indonesia. The Indonesian economy has enjoyed considerable FDI inflows, especially in recent years. Indonesian economic policy has recognised the particular importance of foreign investment for the country's economic development. In particular, Indonesia's most recent round of reforms since the country was hit by the Asian financial crisis in 1998, and the intensifying economic integration with the countries of ASEAN, has led to further policy steps in the direction of liberalisation. This is in stark contrast to some other countries in the region, most notably Japan, China, South Korea and other "Asian tigers", where economic success is often attributed to state-led economic development and a domestic industrial policy that was characterised by only stepwise and controlled opening to international trade and investment.<sup>5</sup> In terms of economic policy-making and governance structures, Indonesian experiences are noteworthy and can offer important lessons for other developing countries.

## 1.2 Methodological approach

In this study, we develop and employ a systematic methodology for the comparative examination of international commitments and national laws and regulations. As illustrated in Figure 1, this method consists of a stepwise approach: first, the analysis starts with a mapping of all IIAs that a country has signed; second, these IIAs are compared with national investment-specific and then investment-related laws; third, individual and controversial measures should be considered in more detail, and their potential implications discussed; and finally, the nature of inter-ministerial coordination and stakeholder consultations related to investment issues should be examined through empirical research.

Throughout these four steps, we develop and employ an innovative pattern-matching technique to compare Indonesia's international commitments on investment with relevant national laws and regulations. Our aim is to examine the interactions and consistency between the two, and evaluate

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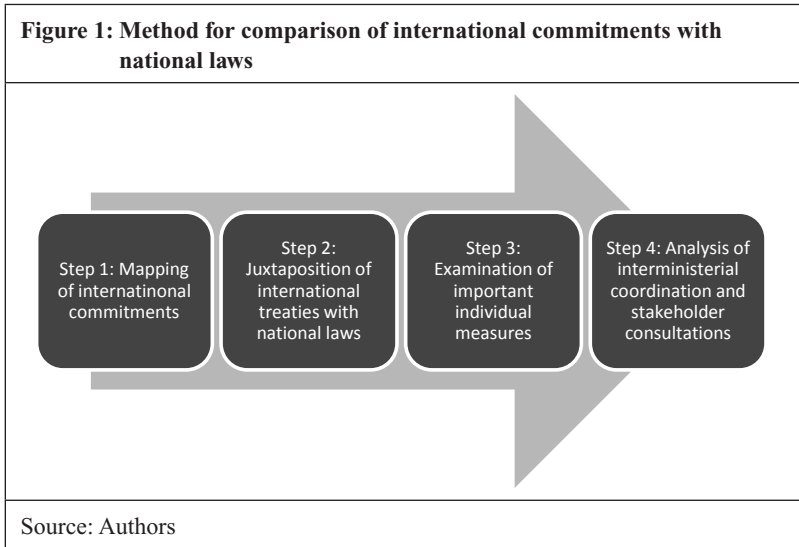
5 Later chapters show, however, that Indonesia has recently begun to make attempts in shifting parts of its economic policy towards a pattern that resembles a more state-directed approach.

the processes and institutional structures involved in bringing Indonesian national and international rules in line with each other. To analyse the above questions, both the commitments made in IIAs and related national laws need to be examined in parallel. Thus, a broad range of legal texts related to Indonesia's investment policy framework were collated and examined for the purposes of this study. Initially, the texts of Indonesia's IIAs were gathered and mapped to allow for comparisons between IIAs along individual provisions and in order to evaluate the extent of the international commitments made by Indonesia. Next, the relevant national laws, regulations and measures – especially those related to investment – were identified, collected and examined. The Indonesian investment-specific laws were identified and their content compared with that of the IIAs. Other investment-related laws were collected and also matched with relevant IIA provisions and investment-specific laws. Legal texts and events in Indonesia up to late 2012 were considered for this study. Developments in 2013 and thereafter were not taken into account.

It has generally been shown that many investors, in practice, do not consider the detailed clauses of IIAs, or sometimes even ignore their existence,<sup>6</sup> though they are more prone to pay attention to national law. This highlights the critical importance of national law, even in relation to international commitments. This entire approach made possible the creation of an overview of Indonesia's entire investment policy framework that included both international treaties and national laws. One major contribution of this study is that it allows for a direct comparison of these two distinct areas of investment law.

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6 In a recent survey, Yackee (2010), for example, found little evidence that IIAs are an important factor in investment decisions of US MNEs. For a similar finding, see also European Commission (2000).



The value of this methodology is that it is quite holistic in examining investment law and policy, and it can provide insights on issues such as consistency between domestic laws and regulations and international commitments, potential risks of inconsistencies, and implications for national policy space and economic development. The methodological approach used within this study is also quite straightforward and can be easily replicated for examinations of other countries and contexts.

Not all material was readily available, and a period of fieldwork in Indonesia was necessary in identifying and gathering many of the legal texts. The fieldwork was also used to gain more insight about the broader political economy dimensions surrounding Indonesian investment law that could not be determined from a mere analysis of legal documents. Fieldwork in Indonesia was undertaken in late July and early August 2012. In addition to the pursuit of legal texts and information about investment policy in Indonesia, meetings with a variety of relevant stakeholders and experts in Indonesia were arranged in order to triangulate the findings gathered through the analysis of IIAs and national investment law. Although government officials constituted the primary source of information, discussions were also held with academics, consultants, representatives of non-governmental organisations and chambers of commerce, and experts from foreign

institutions in Indonesia.<sup>7</sup> Obtaining information from a mix of different stakeholders reduced the likelihood of selection bias. In all, 17 meetings with 24 people from 16 institutions were arranged, each lasting between 45 minutes and 4 hours, summing up to a total of 25 hours of discussions. The primary purpose of these meetings was to source and confirm information about legal texts and other facts and insights related to Indonesia's economic policy. These meetings with experts yielded important and useful information on issues such as Indonesia's current economic and political situation, foreign investment in Indonesia, Indonesia's legal environment for investment and intergovernmental relations among Indonesia's ministries. Since the main purpose of the meetings was to gather and confirm available information rather than seeking opinions or individual viewpoints, most of the information provided in the meetings was verified and cross-checked in available textual sources. The identity of the experts is kept anonymous.<sup>8</sup>

As research on this study's subject of interest is still in its infancy, such in-depth empirical work – combined with a broad examination of laws and legal texts for one country – promises to create the kind of data that is currently needed to gain further understanding about the subject. Future studies could then examine other countries and complement the present study's findings.

## **2 International investment agreements and national investment law**

This chapter provides the conceptual basis for the case study of Indonesia's investment policy. We introduce the basic characteristics of international and national laws relevant to foreign investors. The subsequent section

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7 Meetings were held with staff from the following institutions: Indonesia's Investment Coordinating Board (BKPM); the Coordinating Ministry for Economic Affairs; Bank Indonesia; Bappenas; Bapepam-LK; the Ministry of Finance; the Ministry of Foreign Affairs; the Ministry of Trade; the Centre for Strategic and International Studies Indonesia; Definit (Yogyakarta); Kadin (Chamber of Commerce and Industry); the International Institute for Sustainable Development in Jakarta; the Universitas Trisakti; the Delegation of the European Union to Indonesia and Brunei Darussalam; the DEG Representative Office in Jakarta; and the German Embassy in Jakarta.

8 To guarantee anonymity, reference will be made to "experts" rather than providing the names and affiliations of the participants in the discussions.

describes the history and basic characteristics of IIAs as international legal instruments that are designed to offer foreign investors special rights *vis-à-vis* the host state. We then go on to argue that IIAs potentially have a constraining effect on the policy space of host countries. The last section considers the different elements of IIAs and their relationship with specific or related national investment laws.

## 2.1 The global diffusion of IIAs

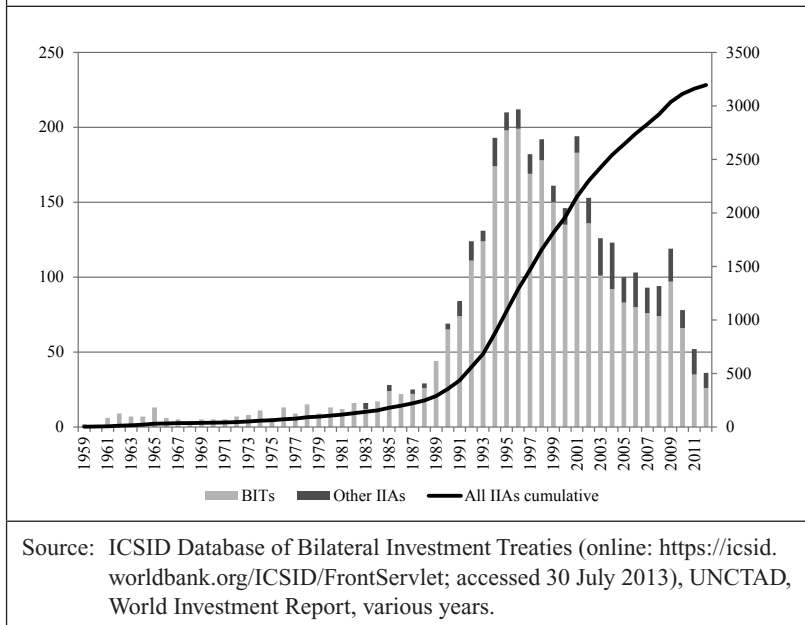
In light of the absence of a comprehensive multilateral investment agreement, FDI flows are governed by a dense network of more than 3,000 IIAs. According to recent data provided by the United Nations Conference on Trade and Development (UNCTAD 2013a, 101), this global network is made up of 2,857 BITs and 339 PTIAs, which are increasingly negotiated on a regional level. The global IIA network evolved along an S-shaped curve that is characteristic of policy diffusion processes (see Figure 2).<sup>9</sup> In the early days of the IIA movement, some European countries started to adopt BITs to protect their national MNEs' investments in politically unstable developing countries. The first BIT was concluded by Germany and Pakistan in 1959. Other Western European countries followed suit and started to negotiate BITs with developing countries (Newcombe / Paradell 2009, 42–43). In this initial phase of the diffusion, no more than 20 agreements were signed each year. At the end of the 1980s, the number of annually concluded BITs increased dramatically, mainly due to the adoption of BITs – being one element of liberal economic reforms in the Washington Consensus era – by Latin American and Central and Eastern European countries. In addition, during the 1990s more and more developing countries started to negotiate so-called South-South BITs among each other. With the turn of the new millennium, the number of newly negotiated BITs declined while investment rules are increasingly being incorporated in PTIAs (e.g. Hofmann / Tams / Schill 2013).

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9 On the policy diffusion concept in general, see Simmons, Dobbin and Garrett (2008).



**Figure 2: Annual and cumulative signed BITs and other IIAs, 1959–2012**



One of the main characteristics of the global IIA network is that these treaties are relatively uniform with regard to their overall structure and content. Capital-exporting countries usually employ standardised IIA models in order to facilitate and simplify negotiations with host countries. In broad terms, the global IIA network can be distinguished into two types of agreements: one offering only investment protection, and the other adding a specified degree of investment liberalisation to complement investment protection. In what follows, we refer to the former as the “protection approach” and the latter as the “liberalisation approach”.

The protection approach is the most widely used and combines strong substantive investment protection in the post-establishment phase with comprehensive ISDS clauses. This approach has been invented and applied first and foremost by European countries. It is also used in most South-South IIAs. IIAs that apply the protection approach establish international standards for the treatment and protection of foreign investors. Standard clauses in such IIAs oblige host states to treat foreign investors fairly and

equitably and to abstain from discriminative measures. Host countries, furthermore, commit themselves to provide compensation in the case of expropriation and to allow the free transfer of investment-related funds. Often, these treaties include so-called umbrella clauses that incorporate all contractual obligations of the host state *vis-à-vis* investors of the other contracting party into the treaty and make them enforceable through the ISDS clauses.

IAs that follow the protection approach are rather short, often comprising not more than 10 pages, and their provisions are drafted in an open-ended and often vague manner. Importantly, these characteristics imply that foreign investors are provided with far-reaching legal protection, whereas these treaties are usually silent on the “rights” of host countries to regulate FDI and the responsibilities of the foreign investors.

A minority of IAs follow the liberalisation approach, which combines investment protection in the post-establishment phase with market-access provisions that grant national treatment and most-favoured nation (MFN) treatment in the pre-establishment phase. This particular approach has been developed by the United States, which started to negotiate BITs in the mid-1980s, and also served as a basis for Chapter 11 on investment of the North American Free Trade Agreement (NAFTA). Canada and a number of other countries such as Japan and Korea are applying the liberalisation approach in some of their BITs. Importantly, this approach is also used as a blueprint for the investment chapters of most PTIAs.

With regard to post-establishment investment protection, IAs modelled on the liberalisation approach are more “balanced”, in the sense that they entail more elaborated and detailed legal language. These treaties provide more clarity with regard to the meaning of substantive provisions, and thus reduce the room for interpretation of arbitration tribunals. In addition, IAs drafted according to the liberalisation approach increasingly include provisions that aim at raising the level of policy space for contracting parties to regulate FDI. Such provisions include, among other things, references to the international minimum standard and customary international law; exclusion of certain public policy fields (e.g. health, environment, social security); and possibilities to deviate from the free transfer of funds obligation in the case of financial crises. These attempts to enhance the clarity of IIA provisions and the exclusion of certain public policies from the coverage of the IIA were a reaction to the NAFTA countries’ experience with a number of high-

profile arbitration claims that were brought against them (e.g. Vandeveldde 2009; McIlroy 2004).

Although the liberalisation approach, broadly speaking, provides more policy space for host countries to implement public policies than the protection approach in the post-establishment phase, this advantage has to be judged against the constraining effect of pre-establishment national and MFN treatment clauses. In contrast to IIAs following the protection approach, IIAs that follow the liberalisation approach include market-access provisions that limit the ability of the host country to screen investments before they are made and to reverse market access in sectors that have been opened up to foreign investors. Of course, the market-access provisions granted to foreign investors in the pre-establishment phase are not unconditional, and the contracting parties usually attach schedules with exceptions to their IIAs. The level of restrictiveness with regard to the host countries' right to admit foreign investments thus depends on these market-access exceptions.

The discussion about the effects of IIAs on the policy space of host countries is so important because substantive protection standards included in these treaties are actually enforceable through third-party arbitral tribunals. In other words, foreign investors that would like to defend their rights against the host country can bypass national courts. What is more, in contrast to the World Trade Organization (WTO), where only governments can launch dispute settlement procedures, MNEs can sue host countries directly in case of alleged breaches of substantive IIA provisions without having to rely on the diplomatic support of their national governments. In short, the de-nationalisation and de-politicisation of the dispute settlement system is a defining feature of the global system of IIAs. Apart from a small number of investment treaty claims brought to international arbitration before 2000, the bulk of claims occurred afterwards (UNCTAD 2013b) and have triggered a debate about the legitimacy of the global IIA system (Franck 2005). By extension, this debate is also about the constraining effects of IIAs on host countries' policy space and the ability of the host state to implement development-friendly policies.

## 2.2 IIA and host-country policy space

The discussion about policy space relates to the flexibility of governments to pursue certain policy measures against the background of their integration in international regimes. More specifically, policy space *“focuses on the tension between international economic integration and the autonomy available to nation states to pursue policies that effectively support their economic development”* (UNCTAD 2008b, 1). It can be sought for both broad economic strategy and for individual policies, and can be viewed specifically in the context of economic development or as a general desire of developing countries to rid themselves from too many external constraints (Page 2007, 2). Examples of economies that have used policy space successfully in the past are mostly found in East Asia (UNDP 2009, 5) – Korea, Japan, China, Taiwan. In particular, many of these economies did not open their capital markets at an early stage of economic development and did not rapidly open up their domestic markets to foreign competition (UNCTAD 2004, 148–149).

It is argued that persisting market failures in developing countries require more state intervention for their resolution, but this possibility to intervene is increasingly being constrained by international efforts towards integration, policy harmonisation and policy consistency (UNDP 2009, 5–6). Integration always has the side effect that domestic flexibility to pursue national economic policy objectives is reduced, as countries are restricted in their use of policy measures because they have made legal commitments under international law. In other words, international economic relationships – established through multilateral, regional or bilateral treaties – minimise control over domestic policy, as foreign players exert some level of influence over domestic policy choices through the concluded treaties (Mayer 2009).

This is not to suggest that integration is always unfavourable to economic development – to the contrary, there are multiple benefits to integration, and the costs of integration may not always outweigh the benefits. Indeed, it is the actual intention of international rules to limit the freedom of individual states to manoeuvre (Page 2007), as states benefit when other countries are obliged to abide by the same rules and there is no “free rider” effect. International rules to which countries are “locked in” provide more certainty than domestic laws.

Thus, developing countries can reap certain benefits from economic integration, but at the same time, they may not be able to maximise the

economic benefits from pursuing development policies crafted to their individual national economic contexts and circumstances. Given this conflict between international integration and national policy flexibility, the challenge for developing countries is in maintaining the appropriate balance between the two. Countries have to evaluate the costs and benefits of international integration *vis-à-vis* national policy flexibility through an effort of conscious calculation. Ensuring that international agreements have sufficient safeguard clauses against the most severe effects of international obligations would be part of such a calculation. Integrating into international regimes in a sequenced manner, in line with a country's economic development status prevailing at any specific time, will also help achieve such a balance (Mayer 2009).

It is important to point out that having policy space does not mean that appropriate use of it is made. In order to use policy space effectively, policy-makers need to have a vision of a country's economic future and be able to formulate clear development strategies in line with the specific domestic circumstances. Governments must have sufficient institutional capacity to proactively advance a national development strategy (UNCTAD 2008b, 3).

The policy space concept is a rather broad – and often underspecified – concept that encompasses a wide range of different policy fields. Policy space has been looked at in the context of macro-economic and monetary policies (UNCTAD 2008b; Mayer 2009), the WTO (DiCaprio / Gallagher 2006; Page 2007) and the General Agreement on Trade in Services (UNDP 2009). Examinations of policy space under the WTO agreements illustrate how difficult it is to measure the concept. DiCaprio and Gallagher, for example, found that the WTO agreements significantly restricted the policy space of developing countries, although there was still room to expand policy space, and not all countries immediately adhered to all commitments (DiCaprio / Gallagher 2006, 799–800). By contrast, Page concludes that

*except for the impact of TRIPS [Agreement on Trade-Related Aspects of Intellectual Property Rights] on technology transfer to and within developing countries, there is little evidence that WTO rules are constraining countries' ability to follow developmental paths.* (Page 2007, 4)

She further acknowledges that “*some rules may reduce potential freedom, but do not restrict current policies; it is impossible to measure their effect*” (Page 2007, 4).

A few studies have addressed the issue of policy space in the context of international investment law. They provide important insights with respect to select IIA provisions (Spears 2010; Romson 2012) or suggest strategies towards drafting development-friendly IIAs (UNCTAD 2012a). Gallagher discusses the lack of possibilities provided in IIAs to mitigate the consequences of financial crises through the introduction of temporary safeguards and other means (Gallagher 2011; 2010). With the notable exception of Manger, who provides an examination of how policy space constrains regulatory flexibility in specific service industries in Chile (Manger 2008), the literature falls short of providing concrete analyses of country-specific contexts. It also does not provide much in-depth consideration of relevant national laws. This study contributes towards filling these gaps in the literature.

Our aim is not to “measure” the policy space that a country such as Indonesia has left in light of its international commitments. Notwithstanding the conceptual difficulties to quantify the policy space of a country, we also doubt the practical relevance of such an approach. First of all, the content of IIAs is often drafted in a broad and often imprecise manner, which impedes the judgement of the concrete impact of a certain treaty clause on policy measures of host countries. Second, even though IIAs may appear as especially constraining on paper, their actual impact on a government’s ability to adopt certain policy measures depends on the enforcement of the rules and the pressure from dispute settlement provisions in IIAs. Despite the recent increase in ISDS cases, we assume that, in most cases, dispute resolution is considered by foreign investors as a measure of last resort.

Against this background, from a policy perspective it is more important to focus on the question of how host states manage the interactions of international and national rules for the governance of FDI with the aim of reducing liabilities *vis-à-vis* foreign investors and their home countries. It is therefore of importance to analyse to what extent states incorporate international commitments in national laws and regulations and how consistent both sets of rules are.

### 2.3 IIAs and national law

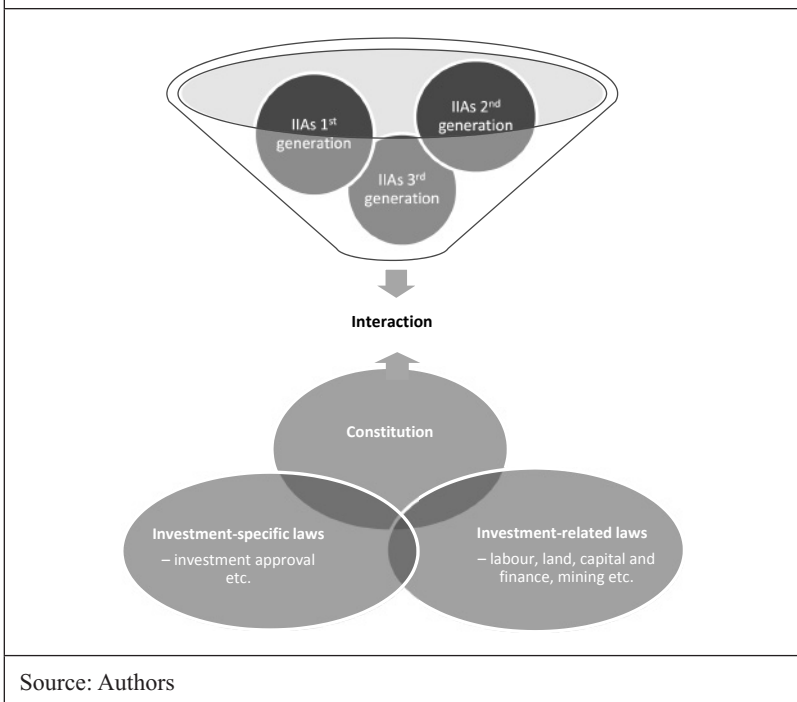
Before analysing the Indonesian case in depth, it is important to briefly consider the nature of the international framework governing investment

and compare it to the general characteristics of domestic legal frameworks. Although the international system of rules on investment is said to be fraught with inconsistencies and incoherence resulting from its nature as a network of treaties (the “spaghetti bowl” phenomenon), overall the organisation of each country’s IIAs is not as complicated as one might expect. At the core of a typical treaty is a set of practically identical formulations, so-called core elements (UNCTAD 2008a), found in most – if not all – of a country’s IIAs. These similarities stem from the above-mentioned common historic origin of IIAs and the fact that capital-exporting countries negotiate IIAs on the basis of model texts. Among the IIAs’ core elements are broad definitions of the covered investments and investors and provisions on expropriation, fair and equitable treatment, national treatment, MFN treatment, transfer of funds, and ISDS. Differences between a country’s IIAs originate primarily in three ways: first, through inclusion of additional non-core provisions, such as the prohibition of performance requirements, the inclusion of an umbrella clause or a denial of benefits clause, in some treaties but not others; second, by developing, in each treaty, nuances and variations of formulations, including those in core provisions, such as widening the scope of specific provisions to the pre-establishment phase, clarifying indirect expropriation or refining procedural aspects of ISDS; and third, by including treaty-specific exceptions, either schedules in annexes or exclusions of policy areas such as national security or the environment.

These individual variations are indeed a challenge to consistency and coherence, as different IIAs and different IIA generations provide foreign investors with different levels of legal protection. But, in effect, the differences found in the global IIA network are levelled off as a result of extensive investor definitions that allow foreign investors, through creative corporate restructuring, to assert their rights through multiple IIAs and by the possibility to “import” more-generous provisions through the MFN clauses. As a result of these characteristics of the global IIA system, Schill (2009) argues that we have a multilateral investment law on the basis of a bilateral treaty system. In other words, even though a country may have negotiated various IIA generations that may differ in their coverage and depth, the above-mentioned multilateralising elements create connections between them, resulting in a cohesive system, as displayed in Figure 3.

The bottom of Figure 3 also provides an illustration of a country’s domestic legal framework governing investment. It is organised quite differently from the framework for IIAs. Contrary to the “multilateralised” network that

**Figure 3: Interactions of different IIA generations and various bodies of national law**



characterises international investment law, the domestic legal framework consists of a variety of distinct and different bodies of law, many of them dealing with issues other than investment, but with the potential to affect some aspects of an investment. These laws exist side by side but are linked to each other in different ways, and may occasionally overlap. A distinction can be made between investment-specific and investment-related laws and regulations. Investment-specific laws are those that are enacted specifically for the purpose of governing investment matters. One example would be the laws governing investment approval. Investment-related laws are laws that are enacted for a broader or different purpose, such as land, labour, finance and capital, or even the Constitution. These laws have the potential to affect investments and have clauses dealing directly or indirectly with investments.



There is little doubt that the domestic legal framework governing investment is more complex than the international one, primarily because legal texts governing matters other than investment have an impact on investment rules and regulations. Coordinating these different laws and keeping them in line with one particular economic strategy is a challenge, especially as competing interests among relevant ministries responsible for drafting the different laws have to be considered. Moreover, this complexity in domestic law does not make it easier to negotiate and conclude appropriate international agreements in accordance with national laws. A particular strategy or approach might be required by a government wishing to bring international commitments in line with domestic rules and regulations. If such an alignment of international commitments – often negotiated in various generations of IIAs with different obligations – with the national legal system fails, the risk to host governments of being sued for breaches in IIA provisions is enhanced.

The degree of policy space available to a country depends on the nature of the interaction between international and domestic investment law and policy and the direction of policy-making. If we were to hypothesise the upper half of Figure 3 as non-existent, a country would have full policy space in the area of investment but would compromise on its level of integration with the rest of the world. Adding treaties in the upper part will have a limiting effect on policy space. This limiting effect should be particularly significant with the initial treaty as a country negotiates its first core IIA provisions and has to adapt domestic investment-specific and -related laws accordingly. In this initial phase, the direction of policy adjustment is clearly from international to domestic law, as the core provisions in IIAs can be considered as an unchangeable given to which national investment laws have to be adjusted. But further intrusion into policy space might diminish after this initial phase as the country negotiates additional provisions, nuances, variations, clarifications and exceptions in subsequent IIAs to conform to the particular demands of negotiating partners. Most countries are today in this latter phase, so the question is how these individually negotiated outcomes affect policy space. This will depend largely on two aspects: first, whether national law forms the basis for adding these additional provisions, variations, exceptions etc., or *vice versa*. Issues such as power differences between negotiation partners, negotiation tactics and the dynamics between domestic ministries play a likely role in determining such direction of rule-making. Second, some of these additional provisions, nuances, variations,

clarifications and exceptions enhance a country's policy space whereas others limit it further. For example, including exceptions for specific industrial sectors, national security, environmental or prudential reasons most likely enhance policy space, whereas adding an umbrella clause will limit it. In sum, the issue of policy space in the context of international investment law and policy is intricately linked with the drafting of national laws and regulations on investment. For this reason, we give the issue of policy space particular consideration within this study.

The remaining part of this section provides a condensed account of the main elements of IIAs, developing conceptually their link to national law. Our approach is to infer how the contents of each provision should be reflected in national laws and regulations. We do not strive for a detailed account of the legal intricacies of international investment law and refer to, among others, Dolzer and Schreuer (2008), Newcombe and Paradell (2009) and relevant UNCTAD publications (e.g. UNCTAD 2012a) instead. Throughout this section, we illustrate the differences between the protection and the liberalisation approach of drafting IIAs and their potential impact on host countries' policy space. This difference is important for the following detailed case study, as Indonesia has signed IIAs according to both of these approaches.

### 2.3.1 Definitions

The definitions of investment and investor in an IIA allow states to specify the coverage of the treaty and to provide for exceptions and exclusions when necessary. Traditionally, IIAs negotiated on the basis of the protection approach cover any kind of asset in the definition of investment and provide an illustrative list of such assets. Due to the broad and open-ended nature of this investment definition, much policy space is yielded. IIAs modelled on the liberalisation approach adopt a different philosophy, as they provide a list specifying the kinds of investments covered by the treaty, thus allowing the contracting parties to tailor the treaty coverage to their specific needs, excluding those investment categories that they do not want to be covered.

In national law, rules on investment not only consider the situation of foreign investors, but also domestic investments and any foreign investments that are not covered by IIAs (such as foreign portfolio investments, when these are excluded from the definition of investment). Thus, national laws should

be broader – or at least equal – in scope with respect to the definitions of investment and investor. As a result, the definitions of investment and investor in IIAs and national law will differ, but if this difference is merely a result of the national rules covering more types of investments and investors, coherence in definitions between national and international rules might still be present for those foreign investments and investors that are covered by IIAs.

### 2.3.2 Admission

Most IIAs adopting the protection approach include an admission clause stating that investments are admitted in accordance with the host country's laws and regulations. IIAs including an admission clause preserve a host country's claim to regulate the entry of FDI. These treaties entail no market-access rights of foreign investors and maintain the host countries' rights to pursue autonomous industrial policies in the pre-establishment phase of an FDI project, that is, among others, the exclusion of specific sectors, screening procedures and equity conditions. Accordingly, absolute and relative standards of treatment of FDI are only in force once the investment has been admitted by the host-country government. In contrast, IIAs following the liberalisation approach include market-access provisions, restricting the host countries' right to choose whether to admit foreign investments, which limits a government's policy space. In other words, such pre-establishment provisions also cover *potential* investments and result in open access by foreign investors in the sectors not excluded in the treaty's annexed schedules. The national treatment, MFN and compensation for losses clauses of such IIAs thus cover the pre- as well as the post-establishment phase of an investment. Despite the market-access clauses included in these treaties, host states can negotiate the exclusion of sectors that they deem to be important in terms of industrial development.

In national law, there are a variety of laws and regulations governing admission. These include, in first instance, the approval procedure, but they can also regulate the acquisition of land rights or business licences. In admitting investments, governments are usually able to maintain broad discretion as to the approval requirements they have *vis-à-vis* foreign investments. However, if pre-establishment commitments have been made in some IIAs, the resulting limitations to such discretion must be reflected in national laws, especially those governing admission and approval.

### 2.3.3 Treatment of investors and investments

Fair and equitable treatment (FET) is a concept largely reserved for IIAs. It is seen as an important prerequisite for attracting investments, as it provides some guarantee that the rule of law and some principles of good governance will be adhered to in the host state. An “unqualified” FET clause, which is adopted in the large majority of IIAs, gives the highest amount of protection to investors. As the FET clause may be understood as protecting the “legitimate expectations” of investors, countries may face limitations in their ability to alternate policies or implement new policies, because any new measures might be interpreted by ISDS tribunals as not conforming to those expectations. One possibility adopted in IIAs modelled on the liberalisation approach is to qualify the FET standard by referring to the minimum standard of treatment under customary international law, or even provide more specific clarifications or lists of what is included in the standard (UNCTAD 2012a, 51). Through such means, policy space can be enhanced by specifying and restricting coverage of the FET standard.

Translating the FET standard into national law is a challenge. For domestic law, committing internationally to apply FET to foreign investors means that any measure taken that may affect investments should conform to the general standard of FET. A large variety of laws and regulations issued by all kinds of ministries in many areas of economic policy-making could potentially violate the FET standard. Dolzer argues accordingly that the FET clause has a particularly deep impact on domestic legislation, “*as it covers all phases of the investments and extends to all areas of domestic law affecting foreign investment*” (Dolzer 2005, 964). Unfortunately, as the FET standard is quite elusive, it could be difficult for any policy-maker to judge whether a new measure is still within the standard and in line with the “legitimate expectations” of foreign investors. It is thus not surprising that FET is most often used in claims brought against governments in ISDS cases.

### 2.3.4 Non-discrimination

The purpose of provisions on non-discrimination is to provide for equal treatment of domestic and foreign investors, that is, national treatment, and foreign investors among each other, that is, MFN treatment. Both

these provisions have the purpose of providing a level playing field for all companies in the host country. They also reduce policy space by minimising the government's ability to legislate in favour of specific companies and investors. Granting national treatment to foreign investments and investors, for instance, will reduce a government's ability to protect certain domestic infant industries and companies from international competition.

There are possibilities to grant national treatment in IIAs while maintaining some degree of policy space. National treatment can be subordinated to domestic laws, derogations from national treatment can be allowed or national treatment can be excluded from certain policy areas, companies (e.g. small and medium-sized enterprises – SMEs), measures or sectors (UNCTAD 2012a, 50; APEC / UNCTAD 2011, 29). Indications that the pursuit of legitimate public policy objectives might lead to certain forms of non-discrimination could be included in an IIA (Spears 2010, 1058–1095). Another approach is to confine national treatment to “like” investors or “like circumstances”. However, the ultimate discretion on what constitutes such “like” investors or circumstances remains with tribunals, which can also decide on the extent to which they wish to consider legitimate public policy concerns in the context of national treatment (Spears 2010, 1057). It is possible to further clarify non-discrimination by adding to an IIA specific and detailed language on the nature of non-discrimination, including what specifically constitutes “like” investors or circumstances. Policy space is highest if national treatment is excluded from an agreement, as it leaves the government full discretion in treating domestic investors more favourably than foreign investors, and the government can introduce all kinds of measures in any sector, even if they are favourable to domestic companies. However, specifically for this reason, national treatment is of key importance for foreign investors and is considered particularly relevant for economic integration.

The MFN clause ensures that foreign investors obtain the best treatment that contracting parties grant to investors from third states. As mentioned above, the MFN provision leads to a levelling of the playing field for foreign investors and to enhanced coherence in international investment law-making. Due to the MFN clauses, which are a standard feature of most IIAs, it may be the case that IIAs are not discriminative *vis-à-vis* third parties. Schill (2009) argues that MFN clauses lead to a “*multilateralization of international investment law*” that is predominantly developed on the basis of bilateral treaties. Through the “multiplying effect” of the MFN

clause (Schill 2009), it is argued that foreign investors can import stronger treatment standards from other IIAs and can benefit from more-generous provisions that the contracting parties negotiated with third countries. While a debate is ongoing about whether such “treaty shopping” reflects the original intention of states negotiating MFN clauses, this characteristic of IIAs, of course, makes it difficult to assess the specific impact of an IIA on the host country’s policy space, as the foreign investor, through the MFN clause, can rely on the more preferential treatment that the host country granted to other foreign investors in other IIAs.

Even though there is less interest for the state to discriminate among foreign investors, carve-outs are made in the MFN clause. Almost standard is the clause that more-favourable treatment is offered to investors from member states of regional economic integration agreements of which the host country is also a member. Matters of taxation are typically excluded from MFN treatment. In addition, ISDS and other policy areas, sectors and enterprises can be excluded from the MFN clause.

Both national treatment and MFN treatment can be granted in the post-establishment phase only, or in both the pre- and post-establishment phases. As mentioned above, the former approach reserves full policy space for the pre-establishment phase, whereas the latter approach will maximise market access for potential investors, but reduce the government’s policy space to a significant degree by granting national and MFN treatment to investments even prior to entry and establishment.

National laws have to be in conformity with the principles of national treatment and MFN treatment. For national treatment, this means that a wide range of laws and regulations – especially laws reflecting a country’s industrial policy or protecting certain enterprises, sectors and industries – must be in accordance with the rules and exceptions provided in IIAs in the pre- and post-establishment phases. More specifically, schedules in IIAs granting national treatment in the pre-establishment phase have to be in accordance with relevant domestic laws and regulations. The process of making sure that such conformity is present and adapting the schedules in pre-establishment IIAs accordingly commonly involves substantial communication among a wide variety of domestic ministries and agencies. The logistics involved in ensuring conformity with the MFN treatment are less complex, given that this standard only concerns equal treatment of foreign investors.

### 2.3.5 Protection of investments

Full protection and security (FPS) is understood to refer to police protection and physical security of an investment, but it can go as far as to include economic, legal and other kinds of protection. All taken together, the FPS standard can inhibit a government to regulate in favour of development objectives. Clarifying the scope of this provision further can help retain some policy space for the host-country government, for example by specifying that FPS means physical security and be linked to customary international law (UNCTAD 2012a, 52).

In addition, host states usually offer protection from strife to foreign investors. Here again, further specifications of what is covered can be helpful in clarifying the liability of the state. The provision is particularly broad if national and MFN treatment are granted for determining the level of compensation in case of damages, but the level of compensation determined should not be seen as impinging to a significant degree on the government's right to regulate.

In national law, protection and security is the responsibility of a country's internal security apparatus and police powers. There may not be much legislation targeted at investors in particular, but when investors are threatened, it is the responsibility of the host state to protect them. This will be reflected in relevant national laws governing activities of the country's security apparatus, including the police and the military. It is important that the laws and regulations in this field – and the security forces themselves – are strong enough to protect investments in case of security threats.

### 2.3.6 Expropriation

Probably the historically most important protection element in IIAs to investors is the protection against expropriation and nationalisation of their investments. Expropriation can be direct and indirect, with indirect expropriation referring to the gradual taking of an investment through regulatory measures. While outright expropriation is the exception rather than the rule today, many claims made in ISDS cases occur on the basis of allegations of indirect expropriation. Thus, if the scope of indirect expropriation is not further clarified in IIAs, a government may lose flexibility in regulating in the public interest because the risk of allegations

that such regulations constitute an indirect expropriation is higher. To overcome this problem, countries adopting the liberalisation approach in their IIAs clarify the scope of indirect expropriation by establishing criteria for indirect expropriations and specifying what kinds of measures do or do not constitute an indirect expropriation. Rules of compensation are again defined in IIAs in case of expropriation, but these should not have significant implications for a government's regulatory policy space.

According to Dolzer, clauses on indirect expropriation have particularly strong relevance to domestic legal systems (Dolzer 2005, 957). National laws should specify property rights and the conditions under which the government is authorised to remove such property rights from the owners. In general, these should conform to expropriation provisions in IIAs. As measures in a broad variety of policy areas could end up being tantamount to an indirect expropriation, governments have to communicate this problem among ministries and agencies, ensuring that the issue of indirect expropriation is taken into account in drafting all kinds of legislation.

### 2.3.7 Transfer of funds

The provision on the free transfer of funds is also a core component of most IIAs, as it guarantees investors the possibility to transfer funds related to their investments – or profits made therefrom – back to the home country or to a third destination. IIAs taking the protection approach usually provide for the free transfer of most funds in and out of the country. However, countries need to take into account that, under certain circumstances, such as when balance-of-payment problems or other financial difficulties emerge in the financial system, such free transfer of funds could have substantial negative effects on macro-economic management (UNCTAD 2012a, 53). Therefore, IIAs with the liberalisation approach usually create exceptions for such circumstances, which provide the government with enhanced policy space, but only in situations where such policy space is needed, and only for a temporary duration.

There are various other possibilities to hedge further against such risks within an IIA. For example, instead of providing an illustrative list of what kinds of funds can be transferred, which is the common approach in IIAs, an exhaustive list could be provided. Reference can also be made to a country's domestic laws and regulations; other exceptions, such as the requirement to



meet certain obligations in the host country prior to the transfer, could be stipulated. In domestic law, one would expect similar provisions in various legal documents governing financial matters, both allowing for the free transfer of funds and specifying exceptions to this rule when circumstances necessitate them.

### 2.3.8 Entry and sojourn of personnel

Many IIAs make provisions on the entry and sojourn in the host state of foreign personnel connected to an investment. Some also have specific provisions for senior management. Generally, setting immigration rules that are very open to the entry of foreign personnel will be seen by investors in a positive light. At the same time, the host state has an interest in enhancing domestic employment. For this reason, it is also hoped that foreign investors recruit as many domestic workers as possible. There is a general understanding that employment can improve the human capital of domestic workers, especially if the firms that are employing are from advanced economies. In light of these considerations, the state has an interest to retain some policy space on the entry and sojourn of personnel so as to balance immigration with local employment in a way that development objectives are met.

Domestic immigration laws control the entry and exit of foreigners to and from a country. Employment and labour laws specify the conditions on the employment of expatriates. These regulations need to be in conformity with concessions made on the entry and sojourn of personnel in IIAs.

### 2.3.9 Dispute settlement

ISDS clauses are a distinctive feature of IIAs. Whereas regional and multilateral trade agreements usually only entail state-to-state dispute settlement procedures, most IIAs provide for ISDS, enabling the foreign investor to sue a host country directly in front of trans-national tribunals. As a result, an investor need not rely on its home state's willingness to defend its rights against the host state. ISDS provisions thus make the above-described substantive provisions enforceable through a de-politicised and de-nationalised process of international arbitration.

Once a case has emerged and an investor is willing to bring a claim to international arbitration, what is important for the state – from a development perspective – is to limit the damage, which includes financial costs, a loss in reputation and negative public perceptions about state actions. The state can limit damages through various approaches in IIAs. It can, for example, specify the conditions under which claims can be brought before international arbitration tribunals, such as by introducing time limitations within which an investor has to bring the case to arbitration after the case initially emerges, or by excluding some IIA provisions from recourse to ISDS. It is also possible to directly limit the amount of compensation that will be paid if an investor wins the case. Another issue is to make all of the ISDS procedures more transparent, for example by requiring that the meetings of the tribunal be open to the public (UNCTAD 2012a, 56–57). Finally, there are also possibilities to encourage or require the parties of a dispute to resolve their conflict amicably (UNCTAD 2010).

As mentioned, limiting the damages from ISDS is important from a development perspective, as the costs of arbitral proceedings and the award can be substantial. Governments might find themselves having to use valuable public funds to compensate investors rather than using these funds to support economic development. If international arbitration cases become too frequent and too costly, governments may start finding themselves in a situation of “regulatory chill”, in which they avoid drafting new measures for public and development purposes due to fear that such action might trigger another case. In this way, ISDS provisions in IIAs that are too broad might indirectly have a negative effect on policy space.

We might expect the availability of the ISDS option to foreign investors to be specified in domestic law. In addition to that, there will be extensive rules on domestic litigation that will also be relevant to foreign investors, as they might be required to initially seek remedies before domestic courts before pursuing international arbitration. Domestic courts and arbitration institutions will be involved in dispute settlement. There should be at least one agency with the responsibility of defending the state in ISDS cases.

### 2.3.10 Investment facilitation and promotion

Investment facilitation refers to the encouragement and promotion of investments in IIAs. Such provisions on investment promotion are

usually non-binding in nature. Host states should have full policy space on how to promote investments, especially as long as the promotion is non-discriminatory and in accordance with other provisions of the IIAs. Examples of investment promotion are the organisation of events for investment promotion, the establishment of investment promotion agencies (IPAs) and the exchange of information on opportunities for investment. The establishment of institutions in the context of the IIA that monitor the agreement could also be considered as investment promotion. Finally, subrogation belongs to this category, since providing for the possibility to subrogate a claim helps promote investments.

Although voluntary commitments to promote investments can be included in IIAs, as is the case in some ASEAN treaties, what matters is the actual promotion activity that happens on the ground. It is primarily domestic laws and regulations and national institutions such as IPAs that determine the extent of promotion activities. Promotion can happen through agencies, but tax and financial incentives are also important in attracting investments. And there may be other means by which governments seek to encourage investments.

### 2.3.11 Investor obligations

It is possible to create obligations for investors in IIAs and domestic law, even if this practice is not very common beyond taxation and customs duties, due to concerns that such obligations could deter investors. “Obligations” can include the requirement of an investor to comply with the host country’s laws and regulations in order to be covered by the treaty. Investors can also be required to comply with international standards in a variety of areas and with corporate social responsibility (CSR) standards (UNCTAD 2012a, 58). Such obligations could help ensure that the activities of foreign enterprises are indeed conducive to economic development.

Technically speaking, investor obligations include taxation measures and customs duties. These are primarily governed in domestic laws and regulations, though many countries have concluded double taxation treaties. With various exceptions on taxation that typically exist in IIAs, countries tend to maintain considerable policy space in this area.

Finally, there is the possibility to not include provisions that commit to the abolishment of investor obligations, which are often found in IIAs following the liberalisation approach. The provisions on performance requirements usually require states to get rid of local content, export and technology-transfer requirements, and other investor obligations. Performance requirements, if existent, are further specified in relevant domestic laws and regulations. Not including provisions on performance requirements enhances policy space for the state, allowing it to maintain some of the performance requirements that can be important for economic development.

### 2.3.12 Scope and exceptions

There are several ways of further defining – and possibly limiting – the scope of a treaty. One possibility is to fix the temporal scope of the treaty by specifying the timeframe within which investments have to be made to be covered by the treaty, usually limiting coverage to investments made after entry into force of the agreement and up to several years after termination of the treaty. However, this approach is discriminatory without a significant reason. A more interesting approach is to exclude investment claims resulting from measures initiated or investments made before entry into force of the agreement. There may not be any need to replicate this issue in national laws and regulations.

More policy space can be attained through the introduction of general exceptions. General exceptions can be made with a variety of issues in mind: national security; economic security; the protection of the environment; public policy areas such as health, public morals, culture and human rights; financial crises etc. It is important to avoid the overuse of these exceptions, which can be done by stating that relevant measures will only be introduced in exceptional circumstances (UNCTAD 2012a). Some possible exceptions were already introduced in the relevant sections above, such as exceptions for situations where there is a crisis with the balance of payments or exceptions for taxation measures. Another typical area is national security, where exceptions can be self-judging – enabling the state to decide in which circumstances the national security exception should be invoked – and non-self-judging, indicating that, ultimately, tribunals may decide on this issue (UNCTAD 2009).

Finally, there is the possibility to maintain certain reservations for specific measures, policy areas, industrial sectors or types of companies. Some sectors may be closed or only partially open to foreign investors, either for national security grounds – especially when these industries are strategic (e.g. telecommunications, banking, natural resources) – or because of development considerations (e.g. when certain industries are to be protected from too much international competition, or when it is hoped that capability-improving cooperation by domestic firms with foreign investors is enhanced by partially limiting foreign entry). Some types of companies, such as SMEs or state-owned enterprises (SOEs), may receive some protection from the government of the host state for development or strategic purposes. There is also the possibility to limit the treaty's application to only certain sectors, but this is not a very common approach, as IIAs tend to apply to all kinds of investments.

Such scheduling of sectors or protection of domestic enterprises should follow a clear development objective and should not inhibit foreign investments in a way that the gains made for development from limiting foreign investments become questionable. If properly and transparently conducted – with objectives of such scheduling clearly stated – the host-country government can enhance its policy space to take measures favourable to certain reserved sectors or enterprises, which could make an overall development contribution to the national economy.

In national law, most reservations and exceptions need to be included in a negative list that specifies the activities and industrial sectors where reservations are maintained and explains any limitations in equity ownership. This list should be in conformity with the schedule attached to IIAs with pre-establishment provisions. Alternatively, providing a positive list is also an option.

### **3 Indonesia's investment policy**

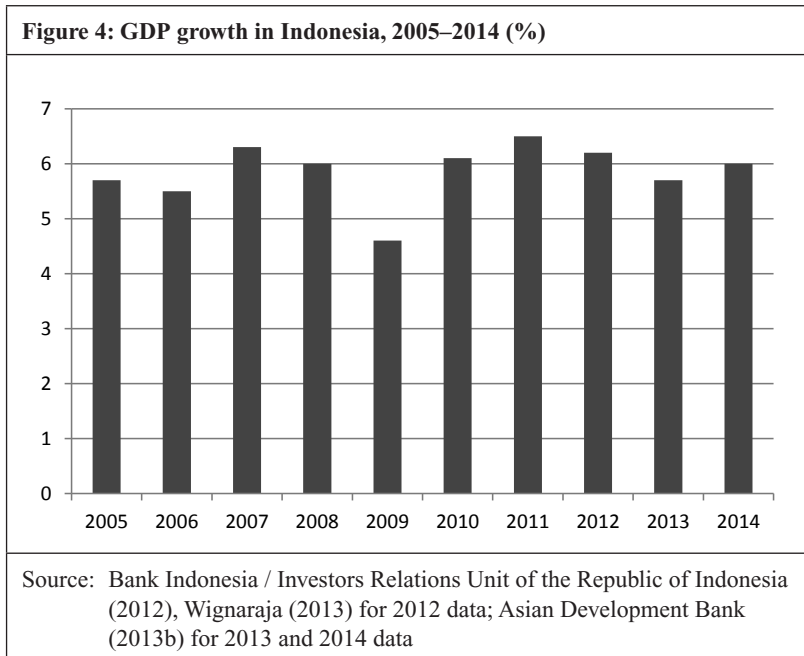
In order to effectively understand how international rules and domestic regulations on investment interact, it is necessary to venture beyond the analysis of IIAs alone – as is generally the case in the literature at hand – and examine in detail how countries deal with this interaction. In this study, we conduct an in-depth examination of the investment laws of a single country, with the objective of understanding how international commitments on

investment are linked to national laws and regulations. We chose Indonesia as a case study for the following reasons. First of all, Indonesia has concluded a large number of IIAs – more than 50 bilateral treaties with advanced, developing and emerging economies, including Japan, Germany and the United Kingdom, as well as several regional treaties in the context of its membership in ASEAN. These regional treaties include the ASEAN Comprehensive Investment Agreement (ACIA) as well as trade agreements between ASEAN and China, South Korea, Australia and New Zealand that include provisions on investment. Secondly, Indonesia has received substantial amounts of FDI from many of its treaty partners. It is Indonesian policy that FDI should play a key role in its economic development. Thirdly, Indonesia's status as a lower-middle-income country ensures that our analysis is relevant to issues of economic development. The study of Indonesia allows us to consider how the interaction of its international and national investment policies relates to its economic development progress. As mentioned, examining how investment rules and regulations affect policy space and economic development is a broader motivation for conducting this study.

The fact that Indonesia underwent ambitious economic reforms in the aftermath of the Asian financial crisis also provides a unique opportunity to examine how a country reforms its economic policy towards greater openness while at the same time preserving policy flexibility. Since the crisis in 1998, and in line with the introduction of democratic institutions, an unprecedented number of laws have been introduced in Indonesia, including new laws on investment matters. In addition, several new institutions have been established (OECD 2010, 27–28). Liberalisation means giving up policy space; other countries in the region, most notably China, Japan, South Korea and some of the “Asian Tigers”, have – in the process of their economic development – taken a more cautious approach than Indonesia towards the issue of liberalisation. For an Indonesia that has already opened up to ASEAN countries and has far-reaching commitments with other countries in the region, including Japan, China, Australia and New Zealand, it is useful to consider how such decisions impact its domestic regulatory apparatus and policy space.

### 3.1 Indonesia's economic context and foreign investment

Indonesia is a developing country with strong economic fundamentals. The country's economic future looks bright, even while the global economy is facing crisis and recession. As shown in Figure 4, growth in gross domestic product (GDP) reached a record 6.5 per cent in 2011. This growth is mainly attributed to strong domestic demand – especially private consumption – and investment. Inflation has been kept at reasonable levels, with consumer price inflation at 4.28 per cent in 2012 (Asian Development Bank 2013a). According to Figure 4, GDP growth slowed to 5.7 per cent in 2013, but slightly higher growth is expected in 2014 (Asian Development Bank 2013b). Indonesia's balance of payments tends towards the positive, even though recent months have shown a reversal towards a trade deficit, blamed on lowered demand for commodities in the world market. Indonesia has a fairly strong surplus in its capital and financial accounts from enhanced inflows of FDI and portfolio investments. The country's foreign exchange



reserves are sufficient, having reached US\$ 112.8 billion by 2012 (Indonesia Investments 2013b). There have also been strong efforts towards a prudent fiscal policy. The government debt-to-GDP ratio has been in continuous decline over the last decade, and was as low as 23.1 per cent in 2012, with a government deficit of only 1.3 per cent of GDP in 2011 (Trading Economics 2013). The banking system is stable, with the capital adequacy ratio at 17.9 per cent and gross non-performing loans at 2.1 per cent in 2012 (World Bank 2013; Investors Relations Unit of the Republic of Indonesia 2012). Based on these strong economic fundamentals, Indonesia has been projected to be among the top global economies in a few decades from now (Drysdale 2012).

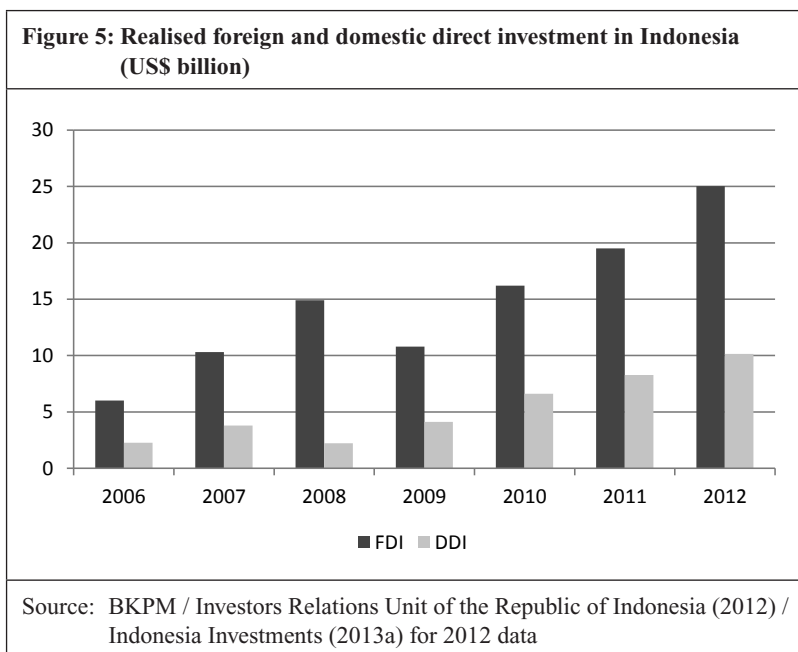
Such a positive economic environment should attract substantial amounts of foreign investment to the country, and there are several other aspects that make the country attractive for investments. For example, Indonesia is abundant in natural resources and has a large potential market of some 240 million consumers, many of whom are now becoming a part of an emerging middle class. This should induce both resource- and market-seeking FDI, respectively. In addition, wages in Indonesia are particularly low (The President Post 2012), as Indonesia is currently benefiting from a demographic dividend, which could induce efficiency-seeking FDI if productivity per worker were enhanced. Indonesia's economy and business climate have recently received more positive rankings than in the past. For example, various credit-rating agencies have improved their ratings for Indonesia, and Indonesia has also improved in the World Economic Forum's Global Competitiveness Index, from rank 54 in 2009/2010 to 44 and 46 in 2010/2011 and 2011/2012, respectively (World Economic Forum 2011, 206). But in 2012/2013 Indonesia was again downgraded to rank 50 (World Economic Forum 2012, 13). Indonesia ranked 9th in A.T. Kearney's 2012 FDI Confidence Index, a significant upward move from the 19th rank it had occupied just two years earlier (A.T. Kearney 2012, 2). However, Indonesia occupied just the 24th rank in A.T. Kearney's 2013 FDI Confidence Index (A.T. Kearney 2013, 3).

Thus, as the recent downgradings also show, there is still much room for improvement, with several important factors posing a disincentive to investment. These include very poor infrastructure, a lack of human capital and a weak legal system (Drysdale 2012). Bureaucracy and flagrant corruption are additional problems (World Economic Forum 2011, 207; Jakarta Globe 2012). One may also see the large number of SOEs, especially



in mining and energy sectors, as a factor that diminishes the attractiveness of Indonesia’s economy. Poverty and large-scale inequality are further problems that Indonesia will need to address. But the most recent downgradings are probably best explained by concerns about recent policy developments that complicate foreign investment in some sectors of the Indonesian economy, as discussed in greater depth in section 3.5 of this study.

Statistics show that investors are ridding themselves of the caution that had prevailed for many years concerning Indonesia as an investment destination, due in part to an unfavourable investment climate (Suryo 2012). As shown in Figure 5, FDI in Indonesia was a mere US\$ 6 billion in 2006, but it had more than doubled to US\$ 14.9 billion by 2008 and more than quadrupled to US\$ 25 billion in 2012 (Indonesia Investments 2013a). In addition to the aforementioned improvements to Indonesia’s economy, reforms to the investment legal system, discussed in further detail below, could be seen as being responsible for the increase in FDI since 2007.



However, Indonesia still lags behind many other Asian countries in terms of the amount of FDI it receives. For example, Indonesia received only 2 per cent of FDI flows from the European Union to Asia in the period between 2004 and 2010, whereas other ASEAN economies received 26 per cent (Eurocham 2012c, 9). According to Table 1, Indonesia still receives quite low amounts of FDI compared to its counterparts in ASEAN. This seems to indicate that Indonesia – the largest country in South East Asia – is not playing out its full potential and that there is much room for FDI flows to increase in future years.

<b>Country</b>	<b>% of GDP</b>
Singapore	25.1
Brunei Darussalam	7.4
Cambodia	6.9
Vietnam	6.2
Lao People's Dem. Rep.	5.8
Malaysia	4.3
Thailand	2.8
<b>Indonesia</b>	<b>2.2</b>
Myanmar	1.6
Philippines	0.6
Source: UNCTAD database	

Table 2 shows the most important home countries of foreign investments in Indonesia. Apart from Singapore – which is in a special situation as an offshore financial centre – FDI in 2011 originated primarily from Japan, the Netherlands and the United States. Current FDI in Indonesia targets a variety of economic sectors, with the manufacturing, mining and transport sectors dominating in 2011 (KPMG 2013, 25). Large businesses tend to be more prominent as foreign investors in Indonesia, especially compared to foreign SMEs.<sup>10</sup>

<sup>10</sup> According to the accounts of two experts.

<b>Table 2: FDI in Indonesia by home country in 2011</b>	
<b>Country</b>	<b>Investment value (US\$ million)</b>
Singapore	5,123
Japan	1,516
Netherlands	1,354
United States	1,488
South Korea	1,219
Malaysia	618
British Virgin Islands	517
United Kingdom	419
Taiwan	243
Germany	158
Hong Kong (SAR)	135
France	134
People's Republic of China	128
Australia	90
Seychelles	80
Mauritius	73
Luxembourg	48
India	42
Switzerland	9
United Arab Emirates	7
Other countries	6,073
<b>Total</b>	<b>19,475</b>
Source: KPMG (2013, 25)	

There seems to be an overall agreement in Indonesia that foreign investment is beneficial for the country and important as a contributor to Indonesian economic development.<sup>11</sup> This is reflected in government policy, which envisages growth of investment – especially private investment – as a potentially significant component of further GDP growth, next to export growth and in parallel with a diminishing role of consumption. The need for foreign financing is recognised as necessary, with FDI likely to make a more valuable development contribution than portfolio investments.<sup>12</sup> As Figure 5 illustrates, FDI has been much higher than domestic direct investment (DDI) in recent years, suggesting that attracting investment from abroad will be key to Indonesia's economic progress. Thus, FDI is sought, encouraged and promoted with much intensity and some success, but amid fierce competition for investments with other regional economic players such as Malaysia and Thailand. As is discussed in further detail below, particular focus has recently been on encouraging and promoting FDI in infrastructure projects to address one of Indonesia's main bottlenecks, that is, the need for more roads, railways, airports, bridges and energy supply in order to generate further economic growth.

Solid economic fundamentals, abundant natural resources and a large market should in themselves be sufficient attractions to foreign investors, possibly minimising the overall importance of a conducive legal or policy environment. In other words, Indonesia might be able to afford more policy space without deterring investments compared to other countries. At the moment, however, investors and other foreign stakeholders are still concerned about the overall policy environment and continue to demand improvements in Indonesia's policy and regulatory environment despite favourable macro-economic conditions (Eurocham 2012b). Indonesia will have to find the right approach to attracting investments while pursuing an investment policy that is in line with the country's economic development objectives.

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11 Many of the experts consulted for this study confirmed this point of view.

12 According to the comments of two experts.

## 3.2 Indonesian international investment policy

Indonesia is an active participant in international treaty-making. It is a member of the WTO, an important member of ASEAN and an active participant in the non-binding liberalisation processes under the auspices of the Asia-Pacific Economic Cooperation (APEC). Indonesia recently pushed for further regional cooperation at the APEC summit in Bali in October 2013. In addition, Indonesia is active in concluding a variety of free trade agreements (FTAs), some including investment provisions, and several other investment agreements at the bilateral level. There are also many double taxation treaties that have been concluded between Indonesia and other countries. Indonesia is a proud member of the G20, which has recently made significant efforts to prevent a backlash towards protectionism in trade and investment after the Anglo-American financial crisis of 2008.

### 3.2.1 Indonesian IIAs

Since the 1960s, Indonesia has been active in concluding various types of IIAs. As shown in Table 3, Indonesia has concluded and ratified BITs with more than 50 countries or economies, has an Economic Partnership Agreement (EPA) with Japan and has concluded four agreements with investment chapters in the context of its ASEAN membership. Indonesia's trajectory of concluding IIAs can roughly be divided into three generations, in line with Indonesia's history of economic policy-making, and especially the progress in liberalising and opening-up the economy.

<b>Table 3: IIAs ratified by Indonesia</b>			
<b>Country or region</b>	<b>Type of agreement</b>	<b>Year of conclusion</b>	<b>Year of entry into force</b>
<b>3rd GENERATION – “Regionalisation”</b>			
Agreement Establishing the ASEAN-Australia-New Zealand Free Trade Area (AANZFTA)	PTIA, Chapter 11	2009	2010

<b>Table 3 (cont.): IIAs ratified by Indonesia</b>			
<b>Country or region</b>	<b>Type of agreement</b>	<b>Year of conclusion</b>	<b>Year of entry into force</b>
Agreement on Investment of the Framework Agreement on Comprehensive Economic Cooperation Between the People's Republic of China and ASEAN	PTIA	2009	2010
ASEAN Comprehensive Investment Agreement (ACIA)	PTIA, developed from the ASEAN Investment Area (AIA) of 1998 and the ASEAN Investment Guarantee Agreement 1987	2009	2012
Agreement on Investment under the Framework Agreement on Comprehensive Economic Cooperation among the Governments of the Member Countries of ASEAN and the Republic of Korea	PTIA	2009	2009
Guyana	BIT	2008	--
Japan	Economic Partnership Agreement (EPA), Chapter 5	2007	2008

<b>Table 3 (cont.): IIAs ratified by Indonesia</b>			
<b>Country or region</b>	<b>Type of agreement</b>	<b>Year of conclusion</b>	<b>Year of entry into force</b>
Russia	BIT	2007	--
Finland	BIT	2006	2008
Iran	BIT	2005	2009
Singapore	BIT	2005	2006
Bulgaria	BIT	2003	2005
Germany	BIT	2003	2007
Saudi Arabia	BIT	2003	2004
Tajikistan	BIT	2003	--
<b>2nd GENERATION – “High tide”</b>			
Croatia	BIT	2002	--
Philippines	BIT	2001	--
Venezuela	BIT	2000	2003
Algeria	BIT	2000	--
Korea DPR	BIT	2000	--
Qatar	BIT	2000	--
India	BIT	1999	2004
Mozambique	BIT	1999	2000
Cambodia	BIT	1999	--
Chile	BIT	1999	--
Jamaica	BIT	1999	--
Zimbabwe	BIT	1999	--
Bangladesh	BIT	1998	1999

<b>Table 3 (cont.): IIAs ratified by Indonesia</b>			
<b>Country or region</b>	<b>Type of agreement</b>	<b>Year of conclusion</b>	<b>Year of entry into force</b>
Czech Republic	BIT	1998	1999
Thailand	BIT	1998	1998
Sudan	BIT	1998	--
Yemen	BIT	1998	--
Cuba	BIT	1997	1999
Mauritius	BIT	1997	2000
Mongolia	BIT	1997	1999
Morocco	BIT	1997	2002
Romania	BIT	1997	1999
Syria	BIT	1997	2000
Turkey	BIT	1997	1998
Jordan	BIT	1996	1999
Pakistan	BIT	1996	1996
Sri Lanka	BIT	1996	1997
Ukraine	BIT	1996	1997
United States	Trade and Investment Framework Agreement (TIFA)	1996	1996
Uzbekistan	BIT	1996	1997
Argentina	BIT	1995	2001
Kyrgyzstan	BIT	1995	1997
Spain	BIT	1995	1997



<b>Table 3 (cont.): IIAs ratified by Indonesia</b>			
<b>Country or region</b>	<b>Type of agreement</b>	<b>Year of conclusion</b>	<b>Year of entry into force</b>
Suriname	BIT	1995	--
China	BIT	1994	1995
Egypt	BIT	1994	1994
Laos	BIT	1994	1995
Malaysia	BIT	1994	1999
Netherlands	BIT	1994	1995
Slovakia	BIT	1994	1995
Turkmenistan	BIT	1994	--
Australia	BIT	1992	1993
Hungary	BIT	1992	1996
Poland	BIT	1992	1993
Sweden	BIT	1992	1993
Tunisia	BIT	1992	1992
Italy	BIT	1991	1995
Korea, Republic of	BIT	1991	1994
Norway	BIT	1991	1994
Vietnam	BIT	1991	1994
Japan	BIT	n.a.	
Libya	BIT	n.a.	
United Arab Emirates	BIT	n.a.	
<b>1st GENERATION – “Exploration”</b>			
United Kingdom	BIT	1976	1977

<b>Country or region</b>	<b>Type of agreement</b>	<b>Year of conclusion</b>	<b>Year of entry into force</b>
Switzerland	BIT	1974	1976
France	BIT	1973	1975
Belgium (and Luxembourg)	BIT	1970	1972
Denmark	BIT	1968	1968
Germany	BIT	1968	1971

Sources: UNCTAD country-specific lists of bilateral investment treaties – Indonesia; ICSID database of bilateral investment treaties; Embassy of the Republic of Indonesia in London – United Kingdom investment guide ([http://www.indonesianembassy.org.uk/invest\\_guide\\_2-E.htm](http://www.indonesianembassy.org.uk/invest_guide_2-E.htm))

The first generation coincided with the beginnings of the Suharto era and the introduction of Indonesia's first national investment-specific laws in 1967 and 1968 for foreign and domestic investors, respectively. Following the introduction of these laws, about half a dozen BITs were concluded with some European industrialised countries such as Denmark, France, Germany and the United Kingdom in the late 1960s and early 1970s. These BITs followed the typical brief format of most BITs concluded at that time – in line with the protection approach – and included provisions such as FET, MFN, expropriation, transfer of funds and in some cases national treatment. This period in Indonesia's BIT programme could be characterised as "explorative", because only very few BITs were concluded, and these BITs exhibited some variations in content and scope. What followed was a long period without the conclusion of any further BITs.

The second generation could be considered as the "high tide" of Indonesia's BIT programme and coincided with a move in Indonesia towards further opening up. It began in the early 1990s and saw the conclusion of most of Indonesia's BITs within a decade – a development that is in line with the global diffusion of BITs, as described in section 2.1. Because Indonesia negotiated on the basis of a model text, these BITs are fairly consistent in

structure, scope and content. With regard to the overall contents, these BITs followed the protection approach. In contrast to BITs of the first generation, probably the most striking feature of the 1990s BIT programme was that most BITs did not provide foreign investors with national treatment. The Asian financial crisis fell within this period of expansion of Indonesia's BIT programme and hit Indonesia most severely of all countries, leading to large-scale outflows of capital. Although some BITs were still concluded at the turn of the century, the fast-paced negotiation of treaties that was so characteristic in the 1990s came to a halt a few years after the crisis.

Probably the most significant change in Indonesia's international investment policy occurred together with the shifts in domestic politics that followed the crisis, triggered by the downfall of the Suharto government and by the requirements for economic and financial reforms imposed by the International Monetary Fund (IMF) as a condition for its financial assistance. With the *demokrasi* movement that culminated in the establishment of a democratic system of government came a series of far-reaching reforms of all parts of the economic system. This period of *reformasi* also led to a reconsideration of the country's investment regime. In addition, rapid economic shifts in East and South East Asia also played a role. With China as an emerging economic power in the north, ASEAN countries were moving closer together, contemplating and signing a series of treaties for closer economic cooperation and liberalisation. ASEAN member states are working on the establishment of an ASEAN Economic Community by 2015, with the objective of developing a single market with free flow of trade, services and investment, together with considerations of equitable economic development and further integration into the global economy.<sup>13</sup>

Economic and political developments in Asia thus became the driving force behind Indonesia's investment policy, which increasingly focused on the regional level. By the mid-2000s, Indonesia and Japan were in discussions about concluding an EPA with commitments on investment that were much more far-reaching than those found in previous Indonesian BITs. These discussions with Japan coincided with preparations for a new domestic law on investment to replace the laws of 1967 and 1968. Both the EPA and Law No. 25 concerning Investment (foreign and domestic combined)

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13 See ASEAN Economic Community Blueprint; online: <http://www.asean.org/archive/5187-10.pdf> (accessed 05 Apr. 2013).

were finalised in 2007. By 2009, the member countries of ASEAN had also succeeded in concluding the ACIA, which entered into force on 29 March 2012.<sup>14</sup> Meanwhile, ASEAN has concluded FTAs with investment provisions with Australia and New Zealand, China and the Republic of Korea, which are implemented progressively. Except for the treaty with China, which only includes protection and promotion provisions (see Berger 2013, 22–24), the agreements signed under the umbrella of ASEAN offer pre-establishment rights and include far-reaching commitments on a variety of other issues, as is common in the liberalisation approach. ASEAN is currently planning and negotiating agreements with additional countries.<sup>15</sup>

This last phase also saw a modest continuation of Indonesia's BIT programme, involving negotiations and renegotiation of about half a dozen BITs. Since the EPA with Japan – and in accordance with the general political trend – commitments made in these BITs were often wider than those found in BITs of the 1990s, going beyond protection and promotion and including provisions on national treatment. With accelerating trends in Indonesia towards liberalisation – including the granting of national treatment in the post- as well as the pre-establishment phase – the first- and second-generation BITs signed before 2000 increasingly appear outdated. As a result, a review of its BIT programme could become an important item on Indonesia's future investment policy agenda. There is a general move towards more comprehensive economic cooperation agreements, also at the bilateral level. For example, negotiations with the European Free Trade Association for an EPA are under way,<sup>16</sup> and there are discussions about a possible Comprehensive Economic Partnership Agreement with the European Union.<sup>17</sup> Such bilateral arrangements stand in competition to efforts made under the umbrella of ASEAN to conclude further agreements with other countries or regions, such as the European Union.

There is a high degree of coherence between Indonesia's model BIT and many of Indonesia's BITs from the 1990s. Some divergences from

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14 See <http://www.aseanbriefing.com/news/2013/04/12/introduction-to-the-asean-comprehensive-investment-agreement.html> (accessed 05 June 2013).

15 According to the accounts of three experts.

16 See <http://www.efta.int/about-efta.aspx> (accessed 10 Sept. 12).

17 Delegation of the European Union to Indonesia, Brunei Darussalam and ASEAN; online: [http://eeas.europa.eu/delegations/indonesia/eu\\_indonesia/trade\\_relation/cepa/index\\_en.htm](http://eeas.europa.eu/delegations/indonesia/eu_indonesia/trade_relation/cepa/index_en.htm) (accessed 07 Nov. 2013).

the model BIT within the 1990s treaties might be a result of individual negotiations, especially with industrialised countries. Although no new model BIT has been formulated, the old Indonesian model BIT can still serve as a background document in negotiations today.<sup>18</sup> Hence, there is little evidence that Indonesia approaches individual countries differently when negotiating IIAs, except for possible differences in negotiating market access for specific sectors and services industries BITs are indeed concluded for political, economic and diplomatic reasons. Even today, the strengthening of diplomatic ties might form a rationale to conclude a BIT.<sup>19</sup>

International negotiations are usually conducted by the appropriate ministry responsible for the economic issues under negotiation, whilst involving the Ministry of Foreign Affairs and other ministries with a stake in the issues being negotiated.<sup>20</sup> The Indonesian Investment Coordinating Board (BKPM) took over responsibility for negotiating BITs and the chapters on investment in ASEAN agreements in 2005.<sup>21</sup> Within the BKPM, there is an institutional separation between those negotiating bilateral agreements and those working on matters of regional cooperation, which includes the ASEAN agreements.

Inter-ministerial consultations and coordination inform any negotiation process, as is elaborated in section 3.6 in greater detail. These internal consultations can be quite complex. There are scheduled meetings where opinions are sought from relevant ministries, such as the Ministry of Trade and the Bank of Indonesia, on draft texts and the matters being negotiated. The Ministry of Foreign Affairs may be involved in such inter-ministerial deliberations, directly or through an advisory role, helping to facilitate agreement. Furthermore, the Coordinating Ministry of Economic Affairs is a key actor in dealings with ASEAN.<sup>22</sup> In ASEAN negotiations on investment, policy agreement among various government agencies is a prerequisite for international negotiations to move forward. Overall, while the negotiator

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18 As suggested by one expert.

19 According to the accounts of two experts.

20 This description reflects the accounts of several experts.

21 According to one expert.

22 This description of the consultation process reflects comments from several experts.

will have some discretion during the negotiation procedures, the ultimate policy authority is shared by various government agencies.<sup>23</sup>

To complicate matters, the process of concluding ASEAN agreements with outside countries is equally complex, given the need to accommodate the varying interests of 10 member states. A caucus among all members to develop a joint position is required before negotiations with external countries move forward. A schedule of commitments is used to incorporate national interests, although all member states have to implement and ratify the commitments within a specified timeframe.<sup>24</sup> There are also occasional footnotes to the agreements to take account of country-specific idiosyncrasies or exceptions. But despite taking account of some national idiosyncrasies, negotiations under a multilateral framework such as ASEAN must necessarily require compromises at the international level that could spill over into national law.

This experience with ASEAN hence suggests that national laws are occasionally adapted in response to international commitments. Nevertheless, when proposals are made by other negotiating parties, conformity with domestic laws and regulations has to be ensured before agreeing to any particular text,<sup>25</sup> implying that national laws inform the conclusion of international treaties. In Indonesia, for most international treaties to be ratified into domestic law, parliamentary approval is normally required,<sup>26</sup> and so the views of parliament are often sought during negotiations. Law No. 24/2000 on International Treaties provides more detail on the required procedures. In sum, it is probably safe to argue that Indonesian national laws and international commitments influence each other, though little evidence exists on the significance or magnitude of these kinds of effects.

Since the more far-reaching agreements following the liberalisation approach have all been ratified only recently, there is no experience yet regarding their impact. What is certain is that Indonesia's recent shift in international investment policy will have an impact on its policy space. On the one hand, the enhanced commitments and market-access provisions

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23 According to one expert.

24 According to one expert. Extensions are possible.

25 According to one expert.

26 See <http://cil.nus.edu.sg/wp/wp-content/uploads/2010/10/Country-Report-Indonesia.pdf> (accessed 05 Apr. 2013).

granted in these treaties will limit policy space in the pre-establishment phase. But on the other hand, many of these newer treaties include a wider range of clarifications, exceptions, specifications and definitions, which may help maintain or enhance policy space in the post-establishment phase. Unfortunately, this dichotomy makes it difficult to draw any final conclusions on this issue.

Similarly, empirical research remains inconclusive about how important international commitments on investment are in attracting FDI.<sup>27</sup> It is plausible that, before making an investment decision, investors will verify whether a suitable IIA exists, but they are unlikely to thoroughly consider all the legal details in those agreements. They will pay much more attention to market factors and business interests. In addition, investors are likely to focus more strongly on the state of local laws and regulations, as these are the legal rules they will have to deal with on a daily basis. The degree to which these laws are enforced and whether the rule of law prevails in day-to-day business practice will matter to investors. This finding – that the detailed legal provisions of IIAs are less important to investors – may endow Indonesia with more flexibility in formulating the content of IIAs than previously thought. At the same time, particular scrutiny and care is required when drafting national law, as investors will review these laws and make decisions based on them. This kind of behaviour that investors seem to exhibit could be considered when future IIAs and national laws are being drafted.

### 3.2.2 Investor-state dispute settlement in Indonesia

When a country enacts measures or implements laws and regulations that are too far-reaching and do not match the commitments made in IIAs, there is a risk that investors may sue governments through international arbitration. In the context of Indonesia's evolving network of IIAs, the few known ISDS cases it has encountered provide a curious picture. According to Table 4, two cases and a third consolidated case against Indonesia have

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27 See e.g. Yackee (2008; 2010) and Berger et al. (2011; 2013).

<b>Table 4: ICSID cases faced by Indonesia</b>					
<b>Registra- tion</b>	<b>Investor</b>	<b>Treaty</b>	<b>ICSID case no.</b>	<b>Subject matter</b>	<b>Outcome</b>
June 2012, December 2012	Churchill Mining and Planet Mining Pty Ltd	UK-Indone- sia BIT of 1976	ARB/12/14 and 12/40	East Kutai coal mining project	Pending
May 2011	Rafat Ali Rizvi	UK-Indone- sia BIT of 1976	ARB/11/13	Banking enterprise	Award ren- dered on 16 July 2013
January 2004	Cemex Asia Holdings Ltd (Sin- gapore/ Mexico)	1987 ASE- AN Agree- ment for the Promotion and Pro- tection of Investments	ARB/04/3	Cement production enterprise	Settlement in the form of an award in 2007
February 1981	Amco Asia Corpora- tion and others	Lease and Manage- ment Agree- ment	ARB/81/1	Construc- tion and operation of a hotel	Award in 1990 after one annul- ment
Source: ICSID website; Lamberti (2012); UNCTAD ISDS database; Vohryzek-Griest (2009)					

been filed at the ICSID alleging a breach of an IIA.<sup>28</sup> The consolidated case and a second case were filed within the last two years, but alleging a breach of one of Indonesia's oldest BITs, namely the Indonesia-UK BIT of 1976. Both cases involved sectors that are in the spotlight of Indonesia's economic policy towards foreign investment, namely mining and banking. Regarding the case in the banking sector, an award was rendered in mid-2013, whereas

28 The oldest case brought against Indonesia at ICSID (Amco Asia Corporation and others v. Republic of Indonesia) did not result from an IIA, but from the breach of a lease and management agreement that provided for recourse to arbitration in case of a dispute. As individual agreements of the government with investors fall outside the scope of this study, there is no need to consider this case in further detail here.



the other consolidated case in the mining sector is still pending. The third case was filed in 2004, alleging a breach of one of the ACIA's predecessors from 1987. This case was terminated by settlement between the parties.<sup>29</sup> Disputes in Indonesia are handled by the Ministry of Law and Human Rights, and the relevant local government might also be involved.

This very recent surge of cases brought against Indonesia at ICSID puts Indonesia under pressure to ensure that its international commitments made under IIAs indeed conform to measures and laws being implemented domestically. It also shows that not only must the new agreements following the liberalisation approach and providing more balanced post-establishment rules be taken into account, but also the very old BITs following the protection approach that might have evaded equal consideration by current policy-makers. Most of these agreements are still in force and may be used by foreign investors to sue Indonesia. Furthermore, the MFN clause, which is a common feature – also of the new, more balanced agreements – might allow investors to “import” more-favourable rules included in older, potentially far-reaching treaties.<sup>30</sup> As mentioned, Indonesia's first agreements were at times more extensive in scope and content than BITs of the 1990s.

Moreover, as the number of IIAs continues to increase, so does the likelihood that claims will be filed against Indonesia. Although renegotiations do not appear much on Indonesia's current policy agenda, an accumulation of disputes or a significant case could spark a round of renegotiations.<sup>31</sup> Both the fact that Indonesia has multilateral and bilateral agreements in parallel, and that the history of IIAs in Indonesia went through three distinct generations, is increasing the level of inconsistency between agreements, which further complicates policy-making on investment. The interaction of these very different IIAs between themselves and with national legislation thus determines, to some extent, the level of available policy space and the degree to which Indonesia may become exposed to international arbitration.

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29 Other cases that illustrate Indonesia's problematic experiences with international arbitration are *Karaha Bodas Company, L.L.C. v. Perusahaan Pertambangan Minyak Dan Gas Bumi Negara*, or in short “*Karaha Bodas v. Pertamina*” (Rubins 2005) and *CalEnergy v. PLN* (Harianto 2012). There was some government involvement in both of these mining and energy cases. Mining is a sector where any future disputes are likely to emerge, given the existence of controversial rules, such as those determining divestment of ownership.

30 On the importance of MFN clauses, see Schill (2009).

31 As was speculated by two experts.

### 3.3 Indonesian national investment policy

Over the last decade, there has been a major shift in investment policy in Indonesia. This shift coincided with democratisation and the overall political and economic reform efforts that were undertaken after the Asian financial crisis. Hardly any areas of economic policy were left untouched, and an array of new laws and regulations emerged during this period. Overall, Indonesia is in favour of portraying itself as an exceptionally liberal developing country, especially compared to other regional players such as China, with its restrictions on capital account transactions and entrenched industrial policies; Japan, with its history of protectionist policies initiated by its Ministry of Economy, Trade and Industry; and Korea, with its own history of limitations on foreign investment. It is not clear whether the initial shift towards liberalisation was conscious or accidental, though the latter is not unlikely, given a certain loss of control after the Asian financial crisis due to reductions in presidential powers, the decentralisation of governance, and less central coordination and monitoring of ministries. The overall policy direction has remained, until today, tilted towards greater liberalisation. There is also no turning back, now that Indonesia is locked into the ASEAN integration process.<sup>32</sup>

Nevertheless, there exists a wide range of views within Indonesia's diverse population on the role that the government should have in economic policy-making and towards liberalisation of trade and investment. Differences in views exist within the government and among its ministries, between various stakeholders and scholars, and within Indonesia's increasingly vocal civil society. For example, some are hoping for Indonesia to formulate a more elaborate industrial policy with a certain level of protection for specific industries, and with a cautious approach towards concluding further FTAs and creating a very open regime for foreign investment. Others, including most international stakeholders, see a successful economic future for Indonesia only in an intensification of efforts towards further liberalisation and economic integration. These stakeholders still see lots of areas where liberalisation is insufficient. While unpopular adjustments to regulations might be required in the short run in order to open up markets, to accommodate free trade and to increase transparency and competition,

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32 This description of Indonesian economic policy was derived from discussions with several experts in Indonesia.

proponents of this view would argue that in the long run, all stakeholders and communities will benefit. ASEAN is seen as a critical player in this process, with prosperity in Indonesia strongly tied to the success of ASEAN integration.<sup>33</sup> Arguably, this entire issue is a subset of a more general and very typical ideological debate that goes beyond the scope of this paper. But it is pertinent to note that this is a subject of major debate within Indonesia, and that contemporary decisions on Indonesia's international and national investment policies are set against this background of competing pressures on government. As a consequence, decisions on economic policy are often a result of compromises, though the general trend is currently towards more openness and as much attraction of investment as possible.

The process of economic reform that started in the late 1990s has not yet been completed, as new laws are still being drafted, and the implementation and enforcement of existing laws are not always complete. Many laws now have to be reviewed because they have not had the intended effect. As a result, there are persistent concerns among foreign investors about the state of Indonesia's regulatory framework, including the enforcement of the rule of law and implementation of good governance principles (Eurocham 2012a).

The Indonesian government has become well-known for its ability to produce a large amount of laws and regulations. Enacting laws and regulations to create legal certainty is, of course, important, but at the same time the existence of too many – and possibly conflicting – rules could actually reduce legal certainty. It has been argued that “*Indonesia has a great inventory of laws/regulations which are often overlapping, inconsistent, or conflicting*” (OECD 2010, 166). Therefore, it is important that an appropriate number of laws are put in place and that these form a coherent framework.

According to Law No. 10/2004 on the Establishment of Laws and Regulations, and subsequent laws, a hierarchy exists among the different kinds of legal texts that are produced by government agencies in Indonesia. The Constitution is the document with the highest standing, followed by the People's Consultative Assembly Decision. Next in line is the Law, followed by Government Regulation, Presidential Regulation, Provincial Regulation and Regency/City Regulation. There are also Presidential Decrees and

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33 This diverse set of views on the role of government and liberalisation of the Indonesian economy was also reflected in the expert discussions conducted for this study.

Ministerial Regulations, or Ministerial Decrees, but their standing in the overall hierarchy is not fully defined (OECD 2012, 12). It should be added that a law or act is a product of the government that must be proposed to parliament and is passed through legislation. Government regulations are less important and can be produced by ministries on the basis of the laws. They do not require parliamentary approval but have to refer to the law. Sub-regulations of a more technical nature are also issued when necessary.<sup>34</sup>

The National Legislation Programme is a formal process that has been put in place to govern legislation in Indonesia. Law No. 10/2004 concerning the Formulation of Laws and Regulations, together with Presidential Regulation No. 61/2005, specify the steps required in the formulation of laws and regulations, which include planning, academic study, initial drafts and parliamentary deliberations (OECD 2010, 169).

### 3.3.1 Economic policy strategy and investment-related laws

The overall direction of economic policy in Indonesia is guided by its five-year plans, which are worked out by Bappenas, the National Development Planning Agency. The establishment of “Medium-Term Development Plans” is governed by Law No. 25/2004 on National Development Planning System. These guidelines are developed in cooperation with ministries, SOEs and local governments, in consultations with investors and other stakeholders (OECD 2010, 128). The development of these plans is an elaborate process involving the preparation of a variety of background papers and three separate books that lay out the specifics of the plan. They also specify budget allocations (Ministry of National Development Planning / National Development Planning Agency 2010). These five-year plans are part of a broader agenda, the National Long-Term Development Plan (RPJPM) 2005–2025, established by Law No. 17/2007.

The National Medium-Term Development Plan (RPJMN) 2010–2014<sup>35</sup> focuses on economic development and people’s welfare; good governance; strengthening of the democratic system; law enforcement and eradication of corruption; and inclusive and just development (Ministry of National Development Planning / National Development Planning Agency 2010,

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34 According to one expert’s explanations.

35 Presidential Decree No. 7/2009.

1–36). Subsequently, investment in the business sector is included as one national priority among 11 others (APEC 2011). In the area of investment, the establishment of one-stop services<sup>36</sup> at the provincial and district levels has been an important part of the current plan, which endeavours to promote investment and achieve more regional balance of investment activities.<sup>37</sup>

In addition, the Coordinating Ministry for Economic Affairs, together with Bappenas, has developed a Masterplan for Acceleration and Expansion of Indonesia Economic Development 2011–2025 (Coordinating Ministry for Economic Affairs of the Republic of Indonesia 2011).<sup>38</sup> Although the Masterplan – also called MP3EI – concentrates on the development of various aspects of the Indonesian economy, such as innovation and human resources, it focuses strongly on infrastructure, addressing one of the key weaknesses of the Indonesian economy. Lack of infrastructure is considered to be the main factor holding Indonesia back in capitalising on its full potential for economic growth. There has been a neglect of infrastructure investment in the country for more than a decade. The Masterplan aims to develop six economic corridors within Indonesia and to increase national connectivity.<sup>39</sup> It is quite specific regarding the type of projects and activities to be pursued. Coordination is sought between central and local governments on implementing these projects. Investment, both private and public, will play an important role in making these projects happen, with specific investments promoted at the central and local levels in specified areas and economic sectors through means such as investment incentives. Foreign investment is expected to significantly contribute to these efforts. The MP3EI also forms part of the other national development plans mentioned above. Revisions of laws and regulations to support activities in line with the Masterplan are anticipated (Coordinating Ministry for Economic Affairs of the Republic of Indonesia 2011).

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36 According to BKPM, one-stop services refers to a “*Service Mechanism in the Front Office (PTSP BKPM) to guide anyone who is looking for investment service assistance.*” See <http://www.bkpm.go.id/contents/general/117122/front-office-mechanism> (accessed 05 June 2013).

37 According to one expert’s explanations.

38 Presidential Regulation No. 32/2011.

39 See [http://www.eurocham.or.id/joomla/index.php?option=com\\_content&view=article&id=210&Itemid=154](http://www.eurocham.or.id/joomla/index.php?option=com_content&view=article&id=210&Itemid=154) (accessed 16 Sept. 2012).

It is difficult to judge whether these various development plans jointly form some kind of coherent industrial policy. There are certainly elements of an industrial policy, but the plans may still be too broad and general to fully qualify as such. The focus is on the development of an overall strategy and policy direction and a discussion of future challenges. Investment forms a particularly important part of the development plans and the Masterplan. There is also a strong focus on economic growth within the Masterplan, but the broader sustainable development benefits for Indonesia and issues of sustainable investment are not widely addressed and could be given more elaborate consideration.

### 3.3.2 Investment-specific laws and regulations

Similar to the three phases of development of international investment policy outlined above, Table 5 shows that Indonesian domestic law on investment also developed in three stages. The first phase, referred to here as the “oil boom era”, followed the enactment of Indonesia’s first investment laws, Law No. 1/1967 concerning Foreign Investment, and Law No. 6/1968 concerning Domestic Investment.<sup>40</sup> For the first time, these laws defined a legal framework for investors, but restrictions on foreign investment were substantial. For example, foreign investments were treated differently than domestic investments in areas such as the establishment of investments, which is why two separate laws were put in place. There was only a positive list of sectors open to foreign investment. Indonesia concluded its first few IIAs during this period.

The second phase, which lasted from the mid-1980s to the turn of the century, saw a slow process of opening up further to foreign investment. The positive list was turned into a negative list in 1986, and 100 per cent equity ownership was allowed in 1994. As shown above, Indonesia’s BIT programme saw its “high tide” during this phase.

The current third phase coincides with Indonesia’s ongoing major economic reform efforts. There has been another round of policy reforms on investment, probably with the most substantial changes to the investment legal framework since the first law on investment came into being. Internationally, Indonesia became involved in the ASEAN process of investment liberalisation and

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40 There were amendments and supplements to these laws a few years after their introduction.

**Table 5: Indonesia’s domestic policy on investment in three stages**

	Oil boom era (1970s to early 1980s)	Liberalisation era (mid-1980s to 2003)	Consolidation era (2003–present)
Overall goal	Economy relying on oil revenue	Economy seeking diversification	A more balanced economy, with various sectors contributing to growth
Policy process	<ul style="list-style-type: none"> <li>• Full government discretion</li> </ul>	<ul style="list-style-type: none"> <li>• Government discretion</li> <li>• Rise of economic technocracy</li> <li>• IMF-mandated reform (from 1997/98 through 2003)</li> </ul>	<ul style="list-style-type: none"> <li>• Various new laws and regulations</li> <li>• Policy transparency, involving stakeholder consultations</li> <li>• Decentralised administration</li> <li>• Reforms are internalised and extended</li> </ul>
FDI policy	<ul style="list-style-type: none"> <li>• High FDI restrictions</li> <li>• Limited number of sectors open to FDI (“positive list” approach)</li> <li>• Strong divestment requirements</li> </ul>	<ul style="list-style-type: none"> <li>• Transformation of “positive list” to “negative list” in 1986</li> <li>• Allowed 100% foreign equity ownership from 1994</li> <li>• Reduced divestment requirements</li> <li>• Reduced minimum initial capital requirement</li> <li>• Eased restrictions to expatriates and use of imported machinery</li> <li>• Incentives for export-oriented investment</li> </ul>	<ul style="list-style-type: none"> <li>• Liberalisation adjusted to domestic conditions and capacity</li> <li>• Regular review of investment list</li> <li>• Equal treatment of foreign and domestic investors</li> <li>• Better investment services</li> <li>• Incentives</li> </ul>
Source: Bahweres (2011)			

pursued more elaborate bilateral agreements, such as the EPA with Japan. Domestically, the most significant change was the replacement of the old and outdated laws of 1967 and 1968 with a new investment law, the Law of the Republic of Indonesia Number 25 of 2007 concerning Investment, which was signed on 27 April 2007 (OECD 2010, 63). The separate laws for foreign and domestic investors were merged into this new single law, thereby granting national treatment to foreign investments. There were a variety of other amendments to the previous laws in favour of foreign investments in areas such as incentive provision, dispute settlement, free transfer of funds and reduction of administrative burdens. Overall, the new law can be seen as more liberal and open to investments; a new negative investment list was developed that is shorter than the previous one, allowing foreigners to invest in sectors that had previously been banned (OECD 2010, 45). There is also a lot of flexibility in reviewing and updating the negative list, which has been done twice since 2007. At the same time, the text of the law appears as a compromise between those who are in favour of liberalisation and those who take a more cautious approach. For example, specific CSR requirements are included in the law, such as an obligation to train local employees and adhere to environmental standards. There are also specific protections for SMEs.

A wide range of ministries were involved in the development of the new investment law, with the BKPM assuming a coordinating role in the process of development and implementation.<sup>41</sup> This is reflected in the law's structure and content, which not only addresses issues relevant to the BKPM, but also the Ministry of Trade; Bappenas and the Capital Market and Financial Institution Supervisory Agency (Bapepam-LK); the Ministry of Industry; the Ministry of Manpower; the Ministry of Mining; the Ministry of Agriculture and others. The enactment of a new investment law was important to get rid of the discriminatory separation of its predecessors and address the challenge of enhanced global competition for investment.

What is interesting about Law No. 25/2007 concerning Investment is its appearance as a kind of interlocking law that connects investment law with other areas of law in Indonesia, but it also provides a link to commitments made in IIAs. In fact, the basic structure of Law No. 25/2007 is not too different from that of IIAs, though the emphasis is sometimes on slightly

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41 This description of the process of developing the law reflects accounts from discussions with several experts in Indonesia.



different issues. Table 6 roughly depicts Indonesia's entire legal framework for investment. It reveals that most issues pertaining to investment are contained, to some degree, in all kinds of laws: from IIAs via Law No. 25/2007 to investment-related national laws and regulations. Depending on the relevant national law, a variety of different government agencies are involved in respective rule-making on investment and the implementation of Law No. 25/2007. The entire framework is extremely complex; maintaining consistency and coherence across the different bodies of law is without doubt a serious challenge. It is also difficult to judge to what extent agencies maintain a right to regulate with respect to column 4, given the international commitments made in column 2 (from left).

As it stands, the Indonesian government has made substantial efforts towards improving the investment climate, including through regulatory means. The investment regime has become faster, simpler and less restrictive, making Indonesia more successful in attracting investments. There is a defined regulatory framework, with investment incentives, special economic zones and one-stop integrated services. Nevertheless, many in the business sector would like to see further reforms made (Eurocham 2011, 31–37; Eurocham 2012b, 7–8). Some concerns remain about the implementation of these new laws, including law enforcement and better application of the rule of law.<sup>42</sup>

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42 Several experts expressed this view.

**Table 6: Indonesia's legal framework for investment**

Issue	IIA provision	Law No. 25/2007 (Investment)	Domestic laws, regulations and plans	Relevant institutions
Intention, objectives	Preamble	Preamble Article 3 (principles and objectives) Article 4 (basic policy of investment) General elucidation		
Definitions	Investment	Article 1 (general provisions), paragraphs 1, 3 Article 2 (general provisions) with elucidation	Law No. 8/1995 (Law of capital market) Law No. 19/2008 (The Sovereign Syariah Securities Government Regulation No. 45/1995 (Capital market organization))	BKPM Bapepam-LK Ministry of Finance (Bank of Indonesia)
	Investor	Article 1 (general provisions), paragraphs 2, 6 Article 5 (form of corporation and domicile)	Law No. 40/2007 (Limited liability companies)	BKPM

**Table 6 (cont.): Indonesia's legal framework for investment**

Issue	IIA provision	Law No. 25/2007 (Investment)	Domestic laws, regulations and plans	Relevant institutions
Admission	Admission clause / pre- and post-establishment	Article 5 (form of corporation and domicile), paragraph 3 Article 21 (investment facility) Article 22 (investment facility) Article 25 (company legalization and licensing), paragraphs (4), (5) Article 26 (company legalization and licensing) Article 27 (coordination and implementation of investment policy) Article 28 (coordination and implementation of investment policy) Article 29 (coordination and implementation of investment policy) Article 30 (organization of investment)	Presidential Regulation No. 27/2009 (One-stop integrated services) Regulation Head of Investment Coordinating Board No. 11/2011 (One-stop shop) Regulation Head of Investment Coordinating Board No. 12/2011 (Investment licences) Regulation Head of Investment Coordinating Board No. 13/2011 (Monitoring and after care) Medium-term development plan (RPJMN), 2010–2014 Law No. 25/2004 (National development planning system) Presidential Regulation No. 36/2010 (List of business fields closed to investment and business fields open, with conditions, to investment) Law No. 5/1999 (Prohibition of monopolistic practices and unfair business competition), Article 4	BKPM ( <i>on behalf of most ministries</i> ) Regional governments KPPU National Land Agency (BPN)

<b>Table 6 (cont.): Indonesia's legal framework for investment</b>				
<b>Issue</b>	<b>IIA provision</b>	<b>Law No. 25/2007 (Investment)</b>	<b>Domestic laws, regulations and plans</b>	<b>Relevant institutions</b>
			<p>Government Regulation No. 57/2010 (Merger or consolidation of business entities and acquisition of company shares that could result in monopolistic practices and/or unfair business competition), Chapter III Regulation of the Commission for the Supervision of Business Competition No. 10/2010 (Notification form for merger or consolidation of business entities and acquisition of company shares)</p> <p>Law No. 22/1999 (Regional government), Article 68, paragraph 1</p> <p>Government Regulation No. 84/2000 (Regional apparatus organization guideline)</p> <p>Act No. 5 of 1960 (Basic provisions concerning the fundamentals of agrarian affairs)</p> <p>Constitution of the Republic of Indonesia, Article 33(3)</p>	

**Table 6 (cont.): Indonesia's legal framework for investment**

Issue	IIA provision	Law No. 25/2007 (Investment)	Domestic laws, regulations and plans	Relevant institutions
Treatment	FET	Article 16 (the rights, obligation and liability of investor)	<i>Potentially all government measures affecting investments</i>	<i>Potentially any agency</i>
Non-discrimination	National treatment	Article 4 (basic policy of investment), paragraph (2)a	<i>Any relevant government measures affecting investments</i> Presidential Regulation No. 36/2010 (List of business fields closed to investment and business fields open, with conditions, to investment)	<i>Any relevant agency</i>
Protection	MFN treatment	Article 6 (treatment to investment)	<i>Any relevant government measures affecting investments</i>	<i>Any relevant agency</i>
Protection	Protection and security	Article 30 (organization of investment), paragraph (1)	Constitution of the Republic of Indonesia, Articles 28G(1), 30(4). <i>General laws on security</i>	POLRI TNI
Protection	Compensation for losses		Constitution of the Republic of Indonesia, Articles 28G(1), 30(4). <i>General laws on security</i>	POLRI TNI

**Table 6 (cont.): Indonesia's legal framework for investment**

Issue	IIA provision	Law No. 25/2007 (Investment)	Domestic laws, regulations and plans	Relevant institutions
Protection	Expropriation	Article 7 (treatment to investment)	Constitution of the Republic of Indonesia, Articles 28H(4) Presidential Regulation No. 65/2006 (The amendment to Presidential Regulation No. 36/2005 on procurement of land for realizing development for public interest) Law No. 20/1961 (Revocation of rights of land and the objects over the land) <i>Any relevant government measures affecting investments</i>	Courts <i>Any relevant agency</i>
Free transfer of funds	Transfer of funds	Article 8 (treatment to investment) Article 9 (treatment to investment)	Act No. 24/1999 (Foreign exchange flow and exchange rate system)	Bank Indonesia Bapepam-LK Ministry of Finance

**Table 6 (cont.): Indonesia's legal framework for investment**

Issue	IIA provision	Law No. 25/2007 (Investment)	Domestic laws, regulations and plans	Relevant institutions
Personnel	Entry and sojourn of aliens / Senior management and board of directors	Article 10 (manpower) Article 11 (manpower) Article 23 (investment facility)	Law No. 13/2003 (Manpower) Government Regulation No. 31/1994 (Alien control and immigration actions) Government Regulation No. 32/1994 (Visas, entry permits and immigration permits) Constitution of the Republic of Indonesia, Articles 26 and 27	Ministry of Manpower Department of Justice Ministry of Law and Human Rights Immigration Office
Dispute settlement	ISDS	Article 32 (dispute settlement)	Law No. 30/1999 (Arbitration and alternative dispute resolution) Supreme Court Regulation No. 1/1990 (Enforcement of foreign arbitral awards) Law No. 5/1968 (Settlement of investment disputes between states and nationals of other states) <i>Other laws on legal enforcement and court procedures</i>	Ministry of Law and Human Rights Courts BANI Local governments

**Table 6 (cont.): Indonesia's legal framework for investment**

Issue	IIA provision	Law No. 25/2007 (Investment)	Domestic laws, regulations and plans	Relevant institutions
Investment facilitation	Investment promotion, institutional arrangements, subrogation	Article 18 (investment facility) Article 19 (investment facility) Article 20 (investment facility) Article 24 (investment facility) Article 28 (coordination and implementation of investment policy), paragraph (1)f	Masterplan (MP3EI) Presidential Regulation No. 27/2009 (One-stop integrated services) Government Regulation No. 1/2007 (Facility of income tax on capital investment in certain business lines and/or certain regions), amended by Government Regulation No. 62/2008; other implementing regulations are: Regulation No. 52/2011, Minister of Finance Decree No. 130/2011 Government Regulation No. 94/2010 (Taxable income calculations and income tax payments for a fiscal year), Article 30 Law No. 17/2006 (Amendment to Law No. 10/1995 on customs)	BKPM Ministry of Finance Ministry of Trade



**Table 6 (cont.): Indonesia's legal framework for investment**

Issue	IIA provision	Law No. 25/2007 (Investment)	Domestic laws, regulations and plans	Relevant institutions
		<p>Regulation of the Finance Minister No. 176/PMK.011/2009 (Exemption from import duty on the imports of machines, goods and materials for the establishment or development of industry in the frame of investment)</p> <p>Law No. 30/2007 (Energy)</p> <p>BKPM Regulation No. 9/2009</p> <p><i>Other laws, regulations and decrees</i></p>	<p>Law No. 39/2009 (Special economic zones)</p>	<p>Ministry of Finance</p>
Investor obligations		<p>Article 10 (manpower), paragraphs (2), (3), (4)</p> <p>Article 15 (the rights, obligation and liability of investor)</p> <p>Article 16 (the rights, obligation and liability of investor)</p> <p>Article 17 (the rights, obligation and liability of investor)</p> <p>Article 33 (sanctions)</p> <p>Article 34 (sanctions)</p>	<p>Law No. 40/2007 (Limited liability companies)</p> <p>Law No. 13/2003 (Manpower)</p> <p>Law No. 32/2009 (Environmental management)</p> <p>Law No. 4/2009 (Mineral and coal mining)</p> <p>Government Regulation No. 18/1999 (Management of the waste of hazardous and toxic materials)</p> <p>Government Regulation No. 74/2001 (Hazardous and toxic substance management)</p>	<p>BKPM</p> <p>Ministry of Manpower</p> <p>Ministry of Environment</p> <p>Ministry of Finance</p> <p>Ministry of Trade</p> <p><i>Other agencies</i></p>

<b>Table 6 (cont.): Indonesia's legal framework for investment</b>				
<b>Issue</b>	<b>IIA provision</b>	<b>Law No. 25/2007 (Investment)</b>	<b>Domestic laws, regulations and plans</b>	<b>Relevant institutions</b>
			Law No. 36/2008 (Income tax) Law No. 33/2004 (Fiscal balance between the central government and the regional governments) Law No. 17/2006 (Amendment to Law No. 10/1995 on customs) Indonesian Customs Tariff Book Law No. 30/2007 (Energy) <i>Other laws, regulations and decrees</i>	
<b>Scope</b>	Timeframe	Article 40 (concluding provisions)		
	General exceptions			

**Table 6 (cont.): Indonesia's legal framework for investment**

Issue	IIA provision	Law No. 25/2007 (Investment)	Domestic laws, regulations and plans	Relevant institutions
	Reservations and schedules	Article 12 (business sector) Article 13 (investment development to micro, small, and medium business, and cooperatives)	Presidential Regulation No. 36/2010 (List of business fields closed to investment and business fields open, with conditions, to investment) Presidential Regulation No. 76/2007 (The criteria and establishment of closed business line and open business with conditions in respect of capital investment) Law No. 20/2008 (Micro, small and medium enterprises) Government Regulation No. 44/2007 (Partnership) Law No. 25/1992 (Cooperatives) Constitution of the Republic of Indonesia, Article 33(2) Masterplan (MP3EI)	Coordinating Ministry of Economic Affairs <i>Other agencies</i>
<p><i>Note:</i> Laws are subject to frequent changes (especially the domestic laws, regulations and plans). The purpose of this table is only to illustrate the linkages between various bodies of law. It does not intend to provide a fully comprehensive account. For translations, see: <a href="http://rulebook-jica.ekon.go.id/index.html">http://rulebook-jica.ekon.go.id/index.html</a></p> <p>Source: Authors</p>				

For the government, difficulties regarding central-local coordination are substantial, with local governments taking varying approaches to the implementation of national laws. Decentralisation and reductions in centralised powers formed part of Indonesia's overall political and economic reform at the turn of the century. In this process, regional governments were given the authority to administer many investment-related matters, such as the issuance of business licences and some taxation matters. There are currently stark differences in regional policies towards investment; some are open whereas others are more restrictive.<sup>43</sup> Although decentralisation might be useful to ensure that specific contexts and development requirements of individual regions are taken into account, it is important that the central government maintains effective coordination and oversight.<sup>44</sup>

### 3.4 Indonesia's international *vis-à-vis* domestic investment law

The purpose of this section is to examine in greater detail the linkages between Indonesia's international commitments on investment made in IIAs and its relevant national laws and regulations. The approach taken is to separately examine individual elements of IIAs and compare them with the relevant domestic investment-specific and investment-related laws. The information provided in Table 6 is used extensively throughout this chapter. We also consider the issue of policy space as well as potential risks resulting from inconsistencies and the use of particular provisions, laws and regulations.

#### 3.4.1 Definitions

Almost all IIAs concluded by Indonesia, especially BITs, apply a broad, "open-ended", asset-based definition of investment that includes an illustrative list, in line with the protection approach in investment treaties. This implies that foreign investments not covered by Indonesia's IIAs will be very few in number, if there are any at all, thereby limiting the flexibility of Indonesia's domestic laws to create particularities for certain types of

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43 This picture of central-local coordination reflects the views of several experts in Indonesia.

44 Decentralisation is covered in Article 18 of Indonesia's Constitution.

investment. Most of Indonesia's IIAs provide that investments need to be conducted "in accordance with the laws and regulations" of the host state, or make use of a similar formulation. This kind of reference to domestic law may reduce risks by helping to limit the liability of the state to claims. The EPA with Japan exceptionally limits the definition of investment by providing that "*a Party may, on a non-discriminatory basis, exclude portfolio investments.*"<sup>45</sup> Some IIAs provide that "*any change in the legal form in which assets are invested or reinvested does not affect their character as investments.*"<sup>46</sup>

Similar to the definitions on investment, the definitions for investor in most Indonesian IIAs are constructed broadly, without many exceptions or limitations. They focus on the distinction between "natural person" and "legal person" or "national" and "company". Both are included within the definition, though the precise wording of the definitions differs between IIAs, and there may be individual nuances in the definition of the two for each contracting party. Some IIAs do provide limitations, including the need to have a substantial interest in the entity or investment,<sup>47</sup> and the possibility to exclude investors from third countries or the host country itself.<sup>48</sup> Other IIAs emphasise that legal person investors need to have "effective" or "real" economic activities in host or home countries.<sup>49</sup> Certain IIAs try to add precision to the fact that investors must come from the other contracting party, for example by adding that a legal entity must be "*actually managed from the territory of that Party.*"<sup>50</sup> A few Indonesian PTIAs include a separate denial of benefits clause,<sup>51</sup> incorporating the possibility to deny the benefits of the treaty to certain kinds of investors. But despite the existence of clarifying sentences in some IIAs, the definition of investor in Indonesian

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45 Indonesia-Japan EPA of 2007, Chapter 5.

46 e.g. Indonesia-Morocco BIT of 1997.

47 Indonesia-Australia BIT of 1992; Indonesia-Denmark BIT of 1968.

48 Indonesia-Turkey BIT of 1997; Indonesia-Spain BIT of 1995; Indonesia-Australia BIT of 1992.

49 Indonesia-Romania BIT of 1997; Indonesia-Morocco BIT of 1997; Indonesia-Turkey BIT of 1997.

50 Indonesia-Spain BIT of 1995.

51 ASEAN Comprehensive Investment Agreement, Article 19; ASEAN-Australia-New Zealand FTA, Chapter 11, Article 11; ASEAN-China FTA, Article 15; ASEAN-Korea FTA, Article 17; Indonesia-Japan EPA, Article 72.

IAs remains very broad overall. This broad approach reduces the policy flexibility of domestic legislators to some extent.

In domestic law, Indonesian Law No. 25/2007 covers only direct investments and excludes portfolio investments.<sup>52</sup> The definition of investment in the interlocking law is thus not in full conformity with Indonesia's IAs. The BKPM has been responsible for direct investments since 1967, whereas portfolio investments, on the other hand, are covered by Law No. 8/1995 concerning the Capital Market and have been managed under the auspices of the responsible agency, Bapepam-LK, since 1995.<sup>53</sup> This includes stock exchange supervision, but excludes sovereign debt and government bonds, which are managed by the Ministry of Finance.<sup>54</sup> This approach makes sense, considering the different natures of direct and portfolio investments, though international commitments on investments are being split off into two or more national laws, with different institutions assuming responsibility. The effects of such an approach are unclear, but so far it appears that it has worked in Indonesia.<sup>55</sup> As this study is primarily concerned with FDI, its focus remains on Law No. 25/2007.

In Law No. 25/2007, investment is defined as “any kind of investment activity” rather than “assets”, and “for running business” within Indonesia,<sup>56</sup> which is a variation from the typical definition found in IAs. National law emphasises that investments must be for an entrepreneurial purpose, which might reflect the intention of the creators of the law to emphasise the development role that investments can play. The national law defines investors as “*any individual or corporation that makes investment in form of either domestic or foreign investors*”, where a “*foreign investor shall be any individual foreign citizen, foreign corporation, or foreign state making*

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52 Law of the Republic of Indonesia No. 25/2007 concerning Investment, Chapter I, Article 2 and Elucidation to Article 2.

53 This was confirmed by one expert. At the time of preparation of this study, there were concrete plans to abolish Bapepam-LK and replace it with a different set of institutions.

54 See <http://www.dmo.or.id/en/content.php?section=13> (accessed 19 Sept. 2012).

55 It has been argued that “*Indonesia tries to dampen short term capital inflows ('hot money') in favour of long term capital investment*” (Vision Group 2011, 27). Whether the separation into two laws supports this approach needs to be further investigated.

56 Law of the Republic of Indonesia No. 25/2007 concerning Investment, Chapter I, Article 1, paragraph 1.

*investment within the territory of the Republic of Indonesia.*<sup>57</sup> Article 5(2) of Law No. 25/2007 also requires foreign investors to establish themselves as limited liability companies, in line with Law No. 40/2007 concerning Limited Liability Companies. This approach to the definition of investor is similar to the definitions “national” and “company” in the IIAs.

In line with our expectations outlined in section 2.3.1, the definitions of “investment” and “investor” in national law are broad, especially when Law No. 25/2007 is viewed in parallel with Law No. 8/1995. This reflects Indonesia’s international commitments in this area. The definition of investment covers both domestic and foreign investors, reflecting principles of national treatment. However, it is unclear whether the definition of investment in Law No. 25/2007 covers the same types of investments as in IIAs, given a more specified nature of the definition. The definitions in Indonesia’s IIAs are quite far-reaching, including investments and investors beyond activities for running a business. Thus, the apparent development intention in national law is not replicated in IIAs, illustrating a case where an attempt to extend the use of policy space is not replicated in international treaties.

### 3.4.2 Admission

Except for the PTIAs modelled in line with the liberalisation approach, that is, the ASEAN IIAs and the Indonesia-Japan EPA, Indonesian BITs usually include a separate admission clause. A standard formulation frequently used is:

*Either Contracting Party shall encourage and create favourable conditions for nationals or companies of the other Contracting Party to invest in its territory, and shall admit such investment in accordance with its laws and regulations.*<sup>58</sup>

Including such a reference to the host state’s laws and regulations might lower risks by reducing the liability of the state to some extent. Occasionally, there

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57 Law of the Republic of Indonesia No. 25/2007 concerning Investment, Chapter I, Articles 4 and 6.

58 Indonesia-Hungary BIT of 1992; see also Indonesia-India BIT of 1999; Indonesia-Jordan BIT of 1996; Indonesia-Laos BIT of 1994; Indonesia-Sri Lanka BIT of 1996.

may be some additions made in older BITs,<sup>59</sup> such as further clarifications,<sup>60</sup> a protocol statement<sup>61</sup> or particular reference to an approval procedure.<sup>62</sup> All admission clauses are limited to the post-establishment phase, though some other provisions do have pre-establishment clauses, as is discussed in later sections.

Law No. 25/2007 addresses admission issues in Articles 5, 21, 22, 25 and 26. Articles 5(3) and 25 provide that investments must be made according to the law – referring again to domestic regulations – and as limited liability companies.<sup>63</sup> The required permits shall be obtained and the one-stop integrated services (Article 26) used in the process of establishment. Details on licensing and services provision in areas related to the acquisition of land rights are clarified in Articles 21 and 22. Article 22(4) states that land rights can be withdrawn in particular cases such as when there is “*damage to the public interest*” or the land is used “*in violation with the purpose and objective of such granting of land rights.*” Ownership of land is regulated by Act No. 5 of 1960 on the Basic Provisions concerning the Fundamentals of Agrarian Affairs and, more broadly, Article 33, paragraph 3 of the Indonesian Constitution, which states that “*the land, the waters and the natural resources within shall be under the powers of the State and shall be used to the greatest benefit of the people.*”

There are further areas where the government attempts to make use of its regulatory flexibility to hedge against misconduct. For example, Government Regulation of the Republic of Indonesia Number 57 Year 2010 concerning Merger or Consolidation of Business Entities and Acquisition of Company

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59 See Indonesia-Belgium BIT of 1970; Indonesia-Denmark BIT of 1968.

60 The Indonesia-Germany BIT of 2003 clarifies that “*neither Contracting Party shall in any way impair by arbitrary or discriminatory measures the management, maintenance, use, enjoyment or disposal of investments in its territory of investors of the other Contracting Party.*” The Indonesia-Spain BIT of 1995 includes a similar formulation and adds another provision: “*Each Party shall endeavour to grant the necessary permits relating to these investments and shall allow, within the framework of its law, the execution of contracts related to manufacturing-licenses and technical, commercial, financial and administrative assistance.*”

61 The Indonesia-Malaysia BIT of 1994 specifies in a protocol that national policies “*in respect of the Republic of Indonesia shall mean the policies of Indonesia which have legal effect on foreign investment matters,*” thereby excluding other policies.

62 Indonesia-Egypt BIT of 1994; Indonesia-Vietnam BIT of 1991.

63 See Law No. 40/2007 concerning Limited Liability Companies.



Shares that could Result in Monopolistic Practices and/or Unfair Business Competition helps avoid mergers and acquisitions that distort competition. In particular, investors have to meet post-notification requirements as laid out in chapter III of this law.<sup>64</sup> Pre-notification can also be done on a voluntary basis at the Commission for the Supervision of Business Competition (KPPU), in line with the Regulation of the Commission for the Supervision of Business Competition Number 10 Year 2010 concerning Notification Form for Merger or Consolidation of Business Entities and Acquisition of Company Shares (APEC 2010, 55).

In line with Article 29 of Law No. 25/2007 concerning Investment, the one-stop-shop system was recently established under Presidential Regulation No. 27/2009 concerning One-Stop Integrated Service (PTSP), with the objective to further improve Indonesia's investment climate and facilitate investment in Indonesia by reducing red tape and providing appropriate and convenient services.<sup>65</sup> The time and number of administrative steps required for entering Indonesia as an investor, to seek investment approval and to obtain relevant licences was shortened as entry regulations and licensing procedures were streamlined. What was earlier a process to obtain a letter of approval was now transformed into a registration system, which reduced the processing time via PTSP from seven days to one day (APEC 2010). Most importantly, the BKPM was authorised by most other ministries and agencies to administer the approval forms, grant licences and issue approval on their behalf under the one-stop-shop system.<sup>66</sup> There is now a four-step registration and permit system in place: (1) application to the BKPM,<sup>67</sup> (2) review by the BKPM, (3) receipt of registration certificate or investment principle permit<sup>68</sup> and (4) application for other licences related to the investment<sup>69</sup> (APEC 2010). The Regulations Head of Investment Coordinating Board Nos. 11 (one-stop shop), 12 (investment

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64 See also part four of the Law of the Republic of Indonesia No. 5/1999 concerning Prohibition of Monopolistic Practices and Unfair Business Competition.

65 See <http://www4.bkpm.go.id/contents/general/16/ONE-STOP-SHOP> (accessed 25 Oct. 2013).

66 Ibid.

67 Recommendation from relevant ministries may be required in some cases (APEC 2010).

68 BKPM will cross-check the eligibility of the investment with the negative list (APEC 2010).

69 These may include licences from local governments, such as construction or building permits, location permits or disturbance permit (APEC 2010).

licences) and 13 (monitoring and after care) of 2011 deal with these issues further.

The coordination and organisation of investments among government agencies and between the central government and the regions is specified in Articles 27, 28, 29 and 30 of Law No. 25/2007. The BKPM is given a core role in the coordination and organisation of investments, though certain areas are outsourced to regional governments.<sup>70</sup> There is currently a move, in line with the medium-term development plan, to establish one-stop services for business and investment licensing at the provincial, district and municipal levels. There are already several hundred one-stop shops across Indonesia, and a large majority of districts now have one-stop shops. There are also efforts to improve services in existing one-stop shops. Despite these local developments, foreign investors still have to get initial approval from the BKPM at the central level while domestic investors can approach either the provincial governments directly or the central BKPM.<sup>71</sup> To support the one-stop-shop system, the National Single Window for Investment is being developed.<sup>72</sup> It allows investors to file online applications for licences and obtain non-licence services from an electronic portal.<sup>73</sup>

Overall, there appears to be consistency of admission clauses in IIAs with Indonesian admission procedures and relevant domestic laws. Admission of investments is an area where the government retains some degree of discretion. Although an admission clause requests a government to admit investments, the obligation is on the investor to adhere to all the national laws and regulations governing admission. At the same time, it is important that admission procedures are swift enough not to deter investors. There is a balance to keep between regulatory procedures and the need to attract FDI.

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70 Indonesian Law No. 25/2007, Articles 27, 28, 29, 30.

71 Several experts contributed to this description of the one-stop-shop system.

72 See [http://www.nswi.bkpm.go.id/wps/portal/english/wps!/ut/p/c5/04\\_SB8K8xLLM9MSSzPy8xBz9CP0os3hDAwNPJydDRwMDJzcnA09fRy9TQ9NQIws\\_I\\_1wkA6zeAMcwnFA388jPzdVvyA7rxwAfZ9k9w!!/dl3/d3/L2dBISEvZ0FBIS9nQSEh/#](http://www.nswi.bkpm.go.id/wps/portal/english/wps!/ut/p/c5/04_SB8K8xLLM9MSSzPy8xBz9CP0os3hDAwNPJydDRwMDJzcnA09fRy9TQ9NQIws_I_1wkA6zeAMcwnFA388jPzdVvyA7rxwAfZ9k9w!!/dl3/d3/L2dBISEvZ0FBIS9nQSEh/#) (accessed 20 Sept. 2012).

73 See <http://www4.bkpm.go.id/contents/general/16/ONE-STOP-SHOP> (accessed 25 Oct. 2013).

### 3.4.3 Treatment of investors and investments

The typical approach taken in Indonesian BITs is to grant FET twice within the treaty. First, FET is granted together with “adequate” protection and security in a provision on admission. Second, a similar, sometimes more detailed formulation using the term “fair and equitable treatment” is used within the MFN provision, frequently adding that contracting parties “*shall not impair, by unreasonable or discriminatory measures, the operation, management, maintenance, use, enjoyment or disposal thereof by those investors.*”<sup>74</sup> This seems to be an idiosyncratic Indonesian approach, as it can also be found in the country’s model BIT. Probably due to negotiation outcomes, this twofold approach does not appear in all of Indonesia’s BITs, and much shorter FET provisions exist in some treaties.<sup>75</sup> Normally, there are no further clarifications of the FET standard, which leaves room for interpretation by investors and arbitral tribunals. However, some of Indonesia’s third-generation IIAs, constructed in line with the liberalisation approach – in particular the ACIA of 2009, the ASEAN-Korea Agreement of 2009<sup>76</sup> and the ASEAN-China Agreement of 2009 – clarify FET as an obligation not to deny justice. These agreements also state that a breach of other provisions in the agreement or provisions in a different IIA will not constitute a breach of the FET article.<sup>77</sup> This is repeated in the ASEAN-Australia-New Zealand FTA (AANZFTA), with a clarification that the FET standard does not go beyond what is required by customary international law. The new Indonesia-Finland BIT of 2006 and some older BITs<sup>78</sup> refer explicitly to national laws by subjecting the FET standard to the host country’s laws and regulations. The Indonesia-Morocco BIT of 1997 provides FET “*subject to the strictly necessary measures to maintain the public order.*”<sup>79</sup> Overall, the newer IIAs offer more clarifications to the FET concept, potentially minimising the state’s risks of being sued in

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74 Indonesian model BIT, Articles II.2 and III.1.

75 “*Investments of investors of either Contracting Party shall at all time be accorded fair and equitable treatment.*” See Indonesia-China BIT of 1994.

76 Here, Indonesia is excluded from further clarifications limiting the scope of the FET clause.

77 ACIA of 2009, Article 11.

78 Indonesia-Norway BIT of 1991; Indonesia-Vietnam BIT of 1991; Indonesia-Poland BIT of 1992.

79 Indonesia-Morocco BIT of 1997, Article II.2.

international arbitration. This may reflect a lesson learnt from the recently emerging case law, where a breach in the FET standard is often used as the reason for a claim.

The obligation to treat foreign investors fairly and equitably is a clause specific to IIAs that is, due to its comprehensive nature, difficult to translate into national law. Consequently, in Indonesian national law, Law No. 25/2007 does not explicitly mention FET. Reference is only made to foreign and domestic investors' entitlement to "*right certainty, legal certainty and protection certainty*", information transparency, "*service*", and "*various forms of facility according to the rules of law*" (Article 14). In the law's elucidation, it is pointed out that "right certainty" is only granted if the investor meets its own particular obligations. Here again, the main investment-specific national law on investment does not appear to be fully consistent with international commitments. This might be because FET, by nature, is supposed to specify the protection available, particularly to foreign investors, whereas many investment-related laws – and even completely different laws – could eventually be used to claim a breach of the FET standard.

### 3.4.4 Non-discrimination

Most Indonesian IIAs, especially the older BITs, omit provisions on national treatment entirely, and it is primarily the newer IIAs that incorporate national treatment provisions. Most notably, the ACIA of 2009, the AANZFTA, the ASEAN-Korea FTA and the Indonesia-Japan EPA provide for national treatment, in like circumstances, at the pre- and post-establishment phases of an investment. These agreements allow for reservations that specify when national treatment does not apply. Depending on the agreement, such reservations include existing measures made by central, regional and local governments, to be identified in a schedule where efforts should be made to phase out these non-conforming measures over time. Such reservations may also include the possibility to institute administrative formalities related to investments.<sup>80</sup> This is coherent with Indonesia's post-2007 policy on

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80 ACIA of 2009, Articles 5, 9 and 20; ASEAN-Australia-New Zealand FTA, Articles 4, 12, 14 and 16; ASEAN-Korea FTA, Articles 3 and 15; Indonesia-Japan EPA, Articles 59 and 64.

concluding FTAs and EPAs that mix protection, promotion and liberalisation elements in line with the liberalisation approach.

In other post-establishment IIAs concluded by Indonesia, the national treatment provision, if existent, usually comes with a series of conditions and protocols. The ASEAN-China FTA, for example, excludes non-conforming measures from the national treatment provision – an approach that is borrowed from China’s treaty practice.<sup>81</sup> Other BITs offering national treatment include significant limitations and exceptions.<sup>82</sup> For example, the Indonesia-Finland BIT of 2006 provides, only in the protocol, that:

*The Government of the Republic of Indonesia, while recognizing the principle of national treatment of investments made by investors of the Republic of Finland in the territory of the Republic of Indonesia, reserves the right to maintain limited exceptions to national treatment. This treatment shall in no case be less favourable than Law no. 1 of 1967, as amended in 1970, permits.*<sup>83</sup>

Only a few newer BITs offer national treatment more broadly, with limitations being confined to some further clarifications<sup>84</sup> or a reference to national laws and regulations by subordinating national treatment to the host country’s domestic laws.<sup>85</sup>

Overall, national treatment is an area where Indonesia maintains significant amounts of policy space. At the same time, national treatment is a core standard in IIAs, and its omission may substantially reduce the attraction of Indonesia as an investment location, which is probably why national treatment has increasingly found its way into Indonesia’s IIAs. It should be noted here that, even if national treatment is not generally granted, it is sometimes granted under other provisions of the treaty, such as under

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81 ASEAN-China FTA, Articles 4 and 6. See Berger (2013).

82 Indonesia-Argentina BIT of 1995; Indonesia-Belgium BIT of 1972; Indonesia-Denmark BIT of 1968; Indonesia-Switzerland BIT of 1974.

83 Indonesia-Finland BIT of 2006, Protocol. A similar, more extensive provision is established in the protocol of the Indonesia-Netherlands BIT of 1994.

84 Indonesia-Germany BIT of 2003; Indonesia-Singapore BIT of 2005; Indonesia-Turkey BIT of 1997, Article II, paragraph 2.

85 Indonesia-India BIT of 1999, Article 4; and to some extent, Indonesia-Italy BIT of 1991, Article 4, and Indonesia-Korea BIT of 1991.

compensation for losses. This issue is examined further in the relevant sections of this study.<sup>86</sup>

Similar to the IIAs, Indonesian domestic law was averse to national treatment prior to 2007. As in Indonesia's BITs, national treatment was previously not provided in domestic laws on investment, which were separated into two laws: one for domestic and one for foreign investment (see above).<sup>87</sup> Law No. 25/2007 concerning Investment is a novelty in this regard, as it states that the government is *"to provide the same treatment to any domestic and foreign investors, by continuously considering the national interest."*<sup>88</sup> Such inclusion of national treatment could be considered as a real "watershed" in Indonesian investment policy (Wilson 2011). The phrase "continuously considering the national interest" is there to retain some regulatory flexibility for Indonesia. In its elucidation, the law clarifies that equal treatment *"shall mean that the Government shall refrain from giving different treatment to any investors that have made investment in Indonesia, unless otherwise specified by the rules of law."*<sup>89</sup> The formulation applies to the post-establishment phase of the investment, subordinating national treatment to Indonesia's domestic laws and regulations. It also applies to possible discrimination among domestic investors. The thoughtful ways in which these provisions are phrased helps maintain some regulatory flexibility for the government, but it may function as a disincentive for foreign investors to invest.

One area where separation between foreign and domestic investors is maintained is investment approval. As mentioned before, screening mechanisms are still separate for foreign and domestic investors in the approval process supervised by the BKPM. Limitations on foreign equity ownership also exist in certain sectors, especially in the area of services (APEC 2010). Taxation is the same for foreign and domestic investors (OECD 2010, 21, 195), although there are exceptions in a few select

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86 e.g., see Indonesia-Cuba BIT of 1997; Indonesia-Czech Republic BIT of 1998.

87 One expert pointed out that, previously, the negative list was much larger for foreign than for domestic investors, and more incentives were given to domestic investors compared to those received by foreign companies. The issuance of approval documents also differed between the two.

88 Law of the Republic of Indonesia No. 25/2007 concerning Investment, Chapter III, Article 4, paragraph (2) a.

89 Law of the Republic of Indonesia No. 25/2007 concerning Investment, Elucidation, Chapter III, Article 4, paragraph (2) a.

sectors.<sup>90</sup> All this should not contradict any pre-establishment commitments made in a few select IIAs, as these provide for the necessary reservations and carve-outs. There are still several non-conforming measures in place today, and some sectors may not yet have reached conformity with the national treatment principle. The schedules attached to the IIAs specify the sectors that are being carved out, and these are reviewed periodically.<sup>91</sup>

The shift towards national treatment as part of Indonesia's investment policy was not sudden, as national treatment was incorporated into some treaties before 2007.<sup>92</sup> Nevertheless, especially during this transition from omission of national treatment to its inclusion in IIAs, a large variety of regulations or measures – including those newly adopted by ministries and government agencies – could affect and violate the national treatment standard. Effective inter-ministerial communication and consultations will be important to ensure that any newly issued regulations are in conformity with international commitments in this area.

The other aspect dealing with non-discrimination is the MFN principle. Most Indonesian IIAs include a simple post-establishment MFN clause.<sup>93</sup> Exceptions for regional economic integration agreements are standard, and taxation exceptions are regularly included. In most cases, no further exceptions or limitations are provided.<sup>94</sup> The ACIA of 2009, the ASEAN-China FTA, the ASEAN-Korea FTA of 2009 and the Indonesia-Japan EPA of 2007<sup>95</sup> even provide MFN treatment at the pre-establishment phase. Overall, the chance of unintended treaty shopping is quite high. The ASEAN-China FTA provides for non-conforming measures and limits recourse to dispute settlement to the base treaty, limiting the chances of treaty shopping in that area.

The wording on MFN treatment provided in national law is strongly in line with that typically found in IIAs. Article 6 of Law No. 25/2007 concerning Investment says:

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90 According to one expert.

91 According to comments made by one expert.

92 Indonesia-Germany BIT of 2003.

93 A notable exception is the AANZFTA, which does not have an MFN clause.

94 In rare cases, more clarifications are added in a protocol, such as the Indonesia-Argentina BIT of 1995 and the Indonesia-Germany BIT of 2003.

95 ACIA of 2009, Articles 6 and 20; ASEAN-China FTA, Articles 5 and 6; ASEAN-Korea FTA, Articles 4 and 15; Indonesia-Japan EPA of 2007, Articles 60 and 62.

- (1) *The Government shall provide the same treatment to any investors originating from any countries making investment in Indonesia pursuant to the rules of law.*
- (2) *Treatment set forth in paragraph (1) shall not apply to investor of certain countries that have received privilege by virtue of an agreement with Indonesia.*<sup>96</sup>

The formulation is akin to a post-establishment clause clarifying that investments must be undertaken in accordance with the law to enjoy MFN treatment. It is broadly in line with Indonesia's post-establishment IIAs. An interesting element in the formulation on privileged countries is that reference is made to "an agreement", which could mean IIAs, implying a motivation to avoid treaty shopping. The elucidation provides more clarity, suggesting that

*'Privilege' shall mean the one pertaining to custom union, free trade zone, common market, monetary union, institution of similar kind and agreement between Indonesian Government and foreign governments whose nature is bilateral, regional or multilateral with respect to certain privilege in organizing investment.*

It appears that bilateral agreements – which would include IIAs – are incorporated in this exception.

In starting to grant national and MFN treatment in the pre-establishment phase, Indonesia is significantly lowering its policy space in this area. In particular, such commitments made in multilateral treaties concluded by Indonesia might have a particular lock-in effect. More caution will now be required in enacting any national laws that could have a discriminatory impact on potential and actual foreign investments. The result is a reduction in policy space.

### 3.4.5 Protection of investments

As in Indonesia's model BIT, most BITs refer to "adequate" or "adequate physical" protection and security,<sup>97</sup> rather than the commonly used

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<sup>96</sup> Law of the Republic of Indonesia No. 25/2007 concerning Investment, Article 6.

<sup>97</sup> The Indonesia-Norway BIT of 1991 provides for "*equitable and reasonable treatment and protection.*" The Indonesia-Spain BIT of 1995 refers simply to protection of investments.



formulation of “full” protection and security. Some BITs do not provide for this standard at all, whereas others do provide for “full” protection and security without further clarifications.<sup>98</sup> These discrepancies might be a reflection of negotiation outcomes. The newer ASEAN agreements also offer full protection and security, but provide that “*full protection and security requires each Member State to take such measures as may be reasonably necessary to ensure the protection and security of the covered investments.*”<sup>99</sup> The AANZFTA also limits the concept to customary international law standards.<sup>100</sup> These are attempts to clarify the extent of full protection and security that are typical for agreements following the liberalisation approach.

Most Indonesian IIAs offer investors compensation for losses owing to a range of causes. They often provide a list of such causes, such as “*armed conflict, revolution, a state of investor emergency, revolt, insurrection or riot.*”<sup>101</sup> Most IIAs also offer non-discriminatory treatment in such circumstances, with reference usually made to national and/or MFN treatment. These include the ASEAN agreements and the EPA with Japan,<sup>102</sup> but also many BITs. Some BITs do not offer national treatment, which is in accordance with the model BIT.<sup>103</sup>

In national law, Indonesia addresses the issue of protection and security in a general manner in Law No. 25/2007 concerning Investment, providing that “*Government and/or regional government shall provide business*

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98 See Indonesia-Finland BIT of 2006; Indonesia-Germany BIT of 2003; Indonesia-Thailand BIT of 1998; and Indonesia-Japan EPA of 2007. Some very old BITs also provide for “full” protection and security, such as the Indonesia-United Kingdom BIT of 1976.

99 ACIA of 2009, Article 11.

100 ASEAN-Australia-New Zealand FTA of 2009, Article 6. The same is done in the ASEAN-Korea FTA; however, Indonesia is excepted from this provision.

101 Indonesian model BIT, Article V. The Indonesia-Mozambique BIT of 1999 and the Indonesia-Czech Republic BIT of 1998 provide even further detail on the nature of these causes.

102 The ACIA of 2009, Article 9, only provides for non-discriminatory treatment; all the other ASEAN agreements provide for national and MFN treatment.

103 e.g., the Indonesia-Finland BIT of 2008, the Indonesia-Germany BIT of 2003, the Indonesia-Malaysia BIT of 1994 and the Indonesia-Sweden BIT of 1992 only offer MFN treatment; the Indonesia-India BIT of 1999, the Indonesia-Ukraine BIT of 1996, the Indonesia-Kyrgyzstan BIT of 1995 and the Indonesia-Hungary BIT of 1992 offer both national and MFN treatment.

*certainty and security in the implementation of investment.*”<sup>104</sup> As there is no mentioning of “full” or “adequate” protection and security, the degree of protection and security to be provided could be interpreted as more limited compared to the IIAs, unless “business certainty and security” is interpreted as being akin to “adequate” protection. Compensation for losses is not covered at all in Law No. 25/2007, illuminating another difference between IIAs and national laws. Here again, policy space is being sought in national law, although Indonesia would be expected to fulfil its international commitments in this area.

The Constitution provides that *“every person shall have the right to protection of his/herself, family, honour, dignity, and property, and shall have the right to feel secure against and receive protection from the threat of fear.”*<sup>105</sup> Article 30 of the Constitution refers to the Indonesian National Military (TNI) and the Indonesian National Police (POLRI) as the responsible organs to protect and maintain public order and security.

### 3.4.6 Expropriation

The ASEAN agreements all have elaborate provisions on expropriation. In these treaties, much effort is put into specifying what constitutes an indirect expropriation, and frequent use is made of annexes. In all four ASEAN agreements, the expropriation article does not apply to the issuance of compulsory licences granted in line with the TRIPS agreement in the area of intellectual property rights. The annex of the ACIA of 2009 further specifies that *“an action or a series of related actions by a Member State cannot constitute an expropriation unless it interferes with a tangible or intangible property right or property interest in a covered investment.”*<sup>106</sup> The AANZFTA of 2009 includes a very similar clause in its annex.<sup>107</sup> In the annexes of the ACIA and the AANZFTA, measures of indirect expropriation have to have the same effect as measures of direct expropriation to be considered as such, and whether an expropriation has indeed occurred has to be examined on a case-by-case basis. Here, a measure that reduces the

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104 Indonesian Law No. 25/2007, Article 30, paragraph (1).

105 Constitution of the Republic of Indonesia, Article 28G, paragraph (1).

106 ACIA of 2009, annex 2, paragraph 1.

107 AANZFTA of 2009, annex on expropriation and compensation.

economic value of an investment is not necessarily considered tantamount to expropriation. Other aspects must be considered, such as the government's breach of a prior written commitment, the nature of a measure and whether it affects the investor disproportionately to the public benefit derived from it. Measures of general application that are for legitimate public welfare purposes do not constitute expropriation.<sup>108</sup> The ASEAN-China FTA includes an exception for expropriation of land, which shall be determined in domestic laws and regulations.<sup>109</sup> This vast amount of hedging with respect to the expropriation provision may be a result of recent ISDS cases that have emerged on the basis of this provision, and resembles the more elaborate formulation of provisions typically found in the agreements following the liberalisation approach.

However, the expropriation provisions in Indonesia's BITs are much more general. No BIT clarifies in detail what is meant by indirect expropriation. Instead, some BITs refer to domestic laws and regulations, probably intended as a risk-mitigation strategy to reduce the potential exposure to international arbitration. Several BITs provide for the possibility to undertake a legal or administrative review of measures,<sup>110</sup> and the Indonesia-Japan EPA of 2007 additionally refers taxation measures, which may count as expropriation, to be handled in first instance by domestic courts.<sup>111</sup> The Singapore-Indonesia BIT of 2005 also refers expropriation of land to domestic legislation. It is interesting to note that some BITs grant national or MFN treatment in the context of expropriation.<sup>112</sup>

Article 7 of Law No. 25/2007 handles expropriation, which can only be undertaken according to the law. The government is required to pay the

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108 ACIA of 2009, annex, paragraphs 3–5; AANZFTA, annex on expropriation and compensation, paragraphs 3–5.

109 ASEAN-China FTA of 2009, Article 8, paragraph 4.

110 Indonesia-Singapore BIT of 2005; Indonesia-Germany BIT of 2003; Indonesia-India BIT of 1999; Indonesia-Mozambique BIT of 1999; Indonesia-Czech Republic BIT of 1998; Indonesia-Thailand BIT of 1998; Indonesia-Romania BIT of 1997; Indonesia-Hungary BIT of 1992; Indonesia-UK BIT of 1976.

111 Indonesia-Japan EPA of 2007, Article 65, paragraph 4, together with Article 73. Certain tax measures in Indonesia are excluded.

112 The Indonesia-Belgium BIT of 1970 grants national and MFN treatment and the Indonesia-Germany BIT of 2003 only MFN treatment to foreign investors in this context. The Indonesia-Vietnam BIT of 1991 brings up fair and equitable treatment in the context of expropriation.

market price as compensation. In situations of disagreement, the case can be reviewed by “*another judicial or independent party*” (APEC 2010). If the case remains unresolved, the issue of compensation can be settled by arbitration.<sup>113</sup> The revocation of land rights is dealt with in Presidential Regulation No. 65/2006, which is the amendment to Presidential Regulation No. 36/2005 on Procurement of Land for Realizing Development for Public Interest, and in Law No. 20/1961 on the Revocation of Rights of Land and the Objects Over the Land. Indonesia’s Constitution provides that “*every person shall have the right to own personal property, and such property may not be unjustly held possession of by any party.*”<sup>114</sup> Compared to Indonesia’s international commitments through IIAs, national law appears much less specific on the issue of indirect expropriation but is overall consistent with international obligations. It is worth adding that many government measures – implemented by various ministries and agencies – could eventually be considered as tantamount to expropriation. Coordination among ministries and agencies is therefore also important in this area of investment law.

### 3.4.7 Transfer of funds

The ASEAN agreements have very detailed transfer of funds provisions.<sup>115</sup> Although they provide the usual illustrative list on what types of transfers can be undertaken, implying that other kinds of transfers could also be understood as falling under the free transfers provision, there are some clarifications and exceptions. One exception in all these agreements is the requirement for conformity with the rights and obligations that each ASEAN member state has towards the IMF. All ASEAN agreements also have balance-of-payments exceptions, allowing for temporary derogation from the free transfer of funds when certain specified conditions are met.<sup>116</sup> The ACIA of 2009, the ASEAN-China FTA, the ASEAN-Korea FTA and also, to a more limited extent, the Indonesia-Japan EPA allow the delay or prevention of transfers when laws and regulations that have general

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113 Law No. 25/2007 concerning Investment, Article 7, paragraph (3).

114 Constitution of the Republic of Indonesia, Article 28H, paragraph (4).

115 ASEAN-China FTA (Article 10, paragraph 2) even includes an MFN clause, to be applied to transfers in similar circumstances.

116 ACIA of 2009, Article 16; ASEAN-Australia-New Zealand FTA, Article 4, paragraph 3; ASEAN-China FTA, Article 11; ASEAN-Korea FTA, Article 11.

application are applied in good faith. An exhaustive list of relevant areas is provided, which include issues such as law enforcement, bankruptcy, securities trading, taxation, social security and the requirement to fulfil formalities (e.g. of central banks).<sup>117</sup> The ASEAN-China FTA also specifies that transfers should comply with formalities specified in domestic laws and regulations, as long as these are not contradictory to the obligations under the agreement.<sup>118</sup> Overall, these are efforts that provide the Indonesian government with more legislative flexibility under specified and often temporary conditions.

The transfer provisions in Indonesia's BITs are not as elaborate. Although the Indonesian model BIT suggests the use of an exhaustive list, actual BITs do not follow this approach. In terms of clarifications, some BITs protect the rights of creditors,<sup>119</sup> whereas many others refer to domestic laws by allowing transfer within the scope of a country's laws and regulations.<sup>120</sup> The Indonesia-Finland BIT of 2006 specifies a maximum possible delay of six months for a transfer.<sup>121</sup> Some BITs grant MFN treatment with regard to the provision on transfer of funds.<sup>122</sup> There are further variations in Indonesia's oldest BITs. An interesting variation can be found in the Indonesia-United Kingdom BIT of 1976, which includes an exception for "*exceptional financial or economic circumstances*."<sup>123</sup>

Domestically, Law No. 25/2007 equally provides a non-exhaustive list of funds that can be transferred and repatriated. Such repatriation is to be undertaken in accordance with the rules of law. There are some exceptions, such as for the protection of the rights of creditors, related to taxation,

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117 ACIA of 2009, Article 13, paragraph 3; ASEAN-China FTA, Article 10, paragraph 3; ASEAN-Korea FTA, Article 10, paragraph 2.

118 ASEAN-China FTA, Article 10, paragraph 4.

119 Indonesia-Australia BIT of 1992.

120 e.g. Indonesia-Finland BIT of 2006; Indonesia-Thailand BIT of 1998; Indonesia-Cuba BIT of 1997; Indonesia-Mongolia BIT of 1997; Indonesia-Uzbekistan BIT of 1996; and Indonesia-Egypt BIT of 1994. In the Indonesia-Malaysia BIT of 1994, the term "national policies" is added. The Indonesia-Mozambique BIT of 1999 adds that the use of these laws should not impede on the investor's rights.

121 This period is only three months in the – very elaborately formulated – Indonesia-Spain BIT of 1995.

122 Indonesia-Finland BIT of 2006; Indonesia-Thailand BIT of 1998; Indonesia-Romania BIT of 1997; and Indonesia-Sweden BIT of 1992.

123 Indonesia-United Kingdom BIT of 1976.

to prevent the state from any loss or when legal liabilities still have to be settled.<sup>124</sup> This is broadly in line with Indonesia's BIT programme. Indonesia does not restrict the transfer and repatriation of funds connected to foreign investments, but there are some limitations that help guard some policy space.

Indonesia has been using a floating exchange rate regime, based on supply and demand for its currency, since 1997. Bank Indonesia may, however, intervene in the foreign exchange market if fluctuations become exaggerated (APEC 2010). As the transfer of capital forms a part of the capital account, the central bank is responsible for governing and regulating the movement of funds as part of its macro-prudential policy. The government continuously monitors the movement of funds.<sup>125</sup> Given Indonesia's currently sound economic fundamentals, the emergence of balance of payments or other financial problems is unlikely. Indonesia is committed to the free flow of capital at any time without discrimination regarding the source or amount of capital.

### 3.4.8 Entry and sojourn of personnel

Only very few of Indonesia's IIAs have provisions on personnel. The ACIA of 2009, the Indonesia-India BIT of 1999, the Indonesia-Turkey BIT of 1997, the Indonesia-Sweden BIT of 1992 and the Indonesia-Australia BIT of 1992 provide that entry and sojourn of personnel relevant to the investment should be allowed.<sup>126</sup> The Indonesia-Germany BIT of 2003 has a respective clause in its protocol, suggesting that "prompt consideration" should be given to applications for entry. The Indonesia-Spain BIT of 1995 and the protocol of the Indonesia-Netherlands BIT of 1994 provide that the issuance of permits or licences for the employment of foreigners should be facilitated. Many of these BITs, and the ACIA of 2009, refer to domestic law by subjecting the entry of aliens to the host state's laws and regulations.<sup>127</sup> Finally, the Indonesia-Turkey BIT of 1997 permits investors

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124 Indonesian Law No. 25/2007 concerning Investment, Article 8, paragraphs 3, 4 and 5, and Article 9.

125 According to the accounts of two experts.

126 In the case of the Indonesia-Australia BIT of 1992, this includes senior personnel.

127 Indonesia-Germany BIT of 2003; Indonesia-India BIT of 1999; and Indonesia-Australia BIT of 1992.

*“to engage managerial and technical personnel of their choice, regardless of nationality.”*<sup>128</sup> Similar provisions are incorporated into the ACIA and the ASEAN-Korea FTA. However, in these two agreements, the host state can influence the national composition of members of the board of directors.<sup>129</sup> The ACIA provides further detailed reservations on these matters.<sup>130</sup> Overall, this limited occurrence of provisions on personnel in Indonesia’s IIAs allows Indonesian authorities considerable regulatory flexibility on this issue.

Quite to the contrary, Law No. 25/2007 is very specific on the issue of manpower. Article 10 states that Indonesian nationals should be prioritised in recruitment activities, though experts from foreign countries with specific knowledge and in certain positions can be employed in accordance with the law. In other words, companies can employ expatriates, but only if the expertise they have is not available domestically (APEC 2010). Companies are further required to *“improve the competence of workers of Indonesian citizen through work trainings”* and to *“provide trainings and transfer of technology to workers of Indonesian citizen.”*<sup>131</sup> Article 11 of Law No. 25/2007 deals with the resolution of disputes between foreign companies and domestic workers, advocating out-of-court proceedings in first instance. Article 23 specifies immigration procedures, allowing the entry of foreigners in relation to investments and facilitating the provision of relevant licences and permits. There are clear specifications on the possible length of stay, extensions and changes of residential status. This latter article is broadly in line with the provisions in the few IIAs that deal with the entry of personnel, whereas Articles 10 and 11 appear to venture further beyond.

Other investment-related national laws also deal with the issues of manpower and immigration. Article 23 of Law No. 13/2003 concerning Manpower distinguishes between domestic and overseas manpower placement; according to Article 34, overseas manpower placement shall be regulated by law. Chapter VIII of this law deals with the assignment of expatriates, which requires a licence,<sup>132</sup> and an expatriate assignment plan needs to be drafted

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128 Indonesia-Turkey BIT of 1997, Article II, paragraph 3(b).

129 ACIA of 2009, Article 8; and ASEAN-Korea FTA, Article 7.

130 ACIA of 2009, Article 9.

131 Indonesian Law No. 25/2007 concerning Investment, Article 10.

132 Indonesian Law No. 13/2003 concerning Manpower, Article 42, paragraph (1).

for approval.<sup>133</sup> Expatriates can only be employed in certain positions and for limited time periods.<sup>134</sup> Requirements for transfer of know-how and training of Indonesian personnel are also specified in Article 45 of this law:

- (1) *Employers of expatriates shall:*
- a. *Appoint manpower being Indonesian citizens as counterpart of the employed expatriates for the transfer of technology and expertise from the said expatriates; and*
  - b. *Organize education and training for the Indonesian manpower as meant in letter a according to the qualification of positions assumed by the expatriates*
- (2) *The provision as meant in paragraph (1) shall not apply to expatriates assuming the position of executive directors and/or commissioners.*<sup>135</sup>

The Ministry of Manpower appears to have been deeply involved in drafting relevant sections of Law No. 25/2007. Whereas the Ministry of Manpower handles issues relating to the employment of foreign personnel, the immigration authorities, the Ministry of Law and Human Rights and the Ministry of Justice handle immigration issues more generally, which are determined through government regulations.<sup>136</sup> Articles 26 and 27 of the Indonesian Constitution deal with citizenship and residence in a more general fashion.

In sum, domestic law is much more specific than IIAs on the issue of entry and sojourn of foreign personnel. This might be an indication that Indonesia maintains considerable policy space in this area. Domestic law appears to push for an enhancement of the development contribution of the entry of foreign personnel, requiring in particular the training of local workers and the transfer of technology and know-how. These expectations are enshrined in various bodies of Indonesian domestic law, especially Law No. 25/2007 together with Law No. 13/2003 concerning Manpower. The

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133 Indonesian Law No. 13/2003 concerning Manpower, Article 43, paragraph (1).

134 Indonesian Law No. 13/2003 concerning Manpower, Article 42, paragraphs (4)–(6).

135 Indonesian Law No. 13/2003 concerning Manpower, Article 45. In the elucidation to this article, it is specified that such appointments of staff for “accompanied” training should eventually allow domestic employees to replace the expatriates.

136 e.g. Government Regulation of the Republic of Indonesia No. 31/1994 concerning Alien Control and Immigration Actions of the Republic of Indonesia, and Government Regulation No. 32/1994 concerning Visas, Entry Permits and Immigration Permits.



questions remain as to what extent such requirements for training are – and can be – enforced, and what exactly such training should consist of to make it different from what foreign investors have to do out of necessity. Such efforts to enhance the development contribution of investment are, however, interesting – their effectiveness and value should be explored in further detail in future research.

### 3.4.9 Dispute settlement

There are two types of ISDS clauses in Indonesian IIAs. The first kind of clause, used by the ASEAN agreements and the Indonesia-Japan EPA, includes very comprehensive and detailed provisions in line with the liberalisation approach to investment treaties. The second kind, used in Indonesia's BITs, consists of relatively short and general ISDS provisions following the protection approach. It is clear that, overall, the more elaborate ISDS provisions include more clauses that aim at reducing the potential damages to the host state from investors' claims.

As shown in Table 7, the ACIA of 2009 has the most elaborate ISDS provisions, comprised of a whole section in the agreement. The provision is limited to certain investors and recent cases, and it applies only to specific IIA provisions. Alternatives to arbitration, such as conciliation, are actively encouraged in line with ASEAN's and Asia's general preference for such dispute-resolution methods. There are other interesting clauses, such as on submission of expert reports and transparency. Overall, these provisions are there to create certainty for the host state on the possible implications of the ISDS clause. Some clauses also help mitigate damages, such as through the encouragement of alternatives to arbitration. The other ASEAN agreements and the Indonesia-Japan EPA also have elaborate provisions. In particular, the ISDS provisions in the AANZFTA of 2009 and the Indonesia-Japan EPA of 2007 are very complex. This shows that in the newer PTIAs, much hedging of risks is done in the drafting of the ISDS provision to limit uncertainty and potential damages.

Again, the picture is much different with BITs. The standard Indonesian BIT, in line with the model BIT, provides for amicable settlement prior to arbitration, and then specifies that if no agreement is reached, disputes can be referred to international arbitration (especially applying ICSID rules, and also those of the United Nations Commission on International Trade Law) or

in many cases also conciliation. Only some BITs have additional provisions of some sort. The Indonesia-Denmark BIT of 1968 and the Indonesia-Switzerland BIT of 1974, on the other hand, have no ISDS provision at all. Interesting are formulations in a few bilateral agreements that refer to domestic laws. The Indonesia-Japan EPA of 2007 and some BITs provide that

*the disputing Party shall carry out without delay the provisions of the award and provide in its Area for the enforcement of the award in accordance with its relevant laws and regulations.*<sup>137</sup>

The Indonesia-Morocco BIT of 1997 states that

*the arbitral tribunal shall base its decision on the national law of the Contracting Party involved in dispute in whose territory the investment was made, including the rules relative to conflicts of law, the provisions of this Agreement.*<sup>138</sup>

Similarly, the Indonesia-China BIT of 1994 provides that

*the tribunal shall adjudicate in accordance with the laws of the Contracting Party to the dispute, the provisions of this Agreement as well as generally recognized principle of international law accepted by both Contracting Parties.*<sup>139</sup>

Indonesia has ratified the Convention on the Recognition and Enforcement of Foreign Arbitral Awards of 1958 and the Convention on the Settlement of Investment Disputes between States and Nationals of other States of 1965. The ICSID Convention was ratified by Law No. 5/1968.

In Indonesian investment-specific domestic law, dispute settlement is found in Article 32 of Law No. 25/2007 concerning Investment. Here also, amicable settlement outside of the court system is suggested as the first step prior to any adjudication. If this fails, the law states that disputes should be settled by arbitration, alternative dispute resolution or the courts of justice. Foreign investors are particularly privileged in this article, as they are entitled to settle the dispute through international arbitration, which is an avenue

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137 Indonesia-Japan EPA of 2007, Article 69, paragraph 19. For similar formulations, see Indonesia-Morocco BIT of 1997, Indonesia-Turkey BIT of 1997 and Indonesia-Spain BIT of 1995.

138 Indonesia-Morocco BIT of 1997, Article VIII, paragraph 4.

139 Indonesia-China BIT of 1994, Article 9, paragraph 3d.

explicitly not open for domestic investors.<sup>140</sup> No further provisions are made on this issue. The domestic formulation for ISDS is hence akin to Indonesia's model BIT and the short option outlined above. Detailed elaborations on procedure, limitations in scope and other matters are omitted. Overall, this is in line with Indonesia's BITs, and hence consistency is sought here. But not much has been done to minimise any risks or damages for the host state.

More generally, dispute resolution in Indonesia is governed by Law No. 30/1999 concerning Arbitration and Alternative Dispute Resolution. Arbitration can be used as a method of settlement if both parties agree. The most popular arbitration institution in Indonesia is the Indonesia National Board of Arbitration (BANI), which is also Indonesia's permanent court of arbitration, but there are also the National Mediation Centre, the Indonesian Institute for Conflict Transformation and the Capital Market Arbitration Board for areas related to capital markets (APEC 2010). The Ministry of Law and Human Rights is involved in handling cases that go to international arbitration. Moreover, in the Churchill Mining case, the local government of the East Kutai Regency also became party to the dispute.<sup>141</sup> There is, of course, the domestic court system, which handles the legal cases that do not go to arbitration.

Given that most IIAs – with the exception of some recent agreements – and Indonesian national law only have very generic ISDS provisions, it seems that relatively little has so far been done to reduce any risks of possible claims. This might be explained by Indonesia's relatively positive experience, as it has so far conceded few ISDS cases. However, as more cases begin to emerge, in line with recent developments, a policy shift in Indonesia with regard to ISDS may be a likely result.

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140 Law No. 25/2007 concerning Investment, Article 32.

141 Presidential Decree No. 30/2012 concerning the Appointment of the Government of East Kutai Regency as a party in the international arbitration process at the Centre for Settlement of Investment Disputes related to the request for arbitration for Churchill Mining.

Table 7: ISDS provisions in Indonesian IIAs							
	ACIA	AANZFTA	ASEAN-China FTA	ASEAN-Korea FTA	Model BIT	Indonesia-Japan EPA	Other BITs
	Section B	Section B	Article 14	Article 18		Article 69	
Limitation by investor	Yes (Article 29)	Yes (Article 22)	Yes (paragraph 2)	Yes (paragraph 2)			
Limitation by time	Yes (Articles 29, 34)	Yes (Article 22)	Yes (paragraph 2)	Yes (paragraph 7)		Yes (paragraph 8)	Very rare
Limitation by IIA provision	Yes (Article 32)	Yes (Article 20)	Yes (paragraphs 1, 9, 10)	Yes (paragraph 1)			
Conciliation (alternatives to arbitration)	Encouragement and promotion (Article 30)	Mentioned (Article 20)			Mentioned (paragraph 2)		Regularly mentioned
Amicable settlement	Prior to submission to arbitration (Article 31)	Prior to submission to arbitration (Article 19)	Prior to submission to arbitration, including a possible administrative review (paragraphs 3, 6)	Prior to submission to arbitration (paragraph 4)	Prior to submission to arbitration (paragraph 1)	Prior to submission to arbitration (paragraph 2)	Very common

**Table 7 (cont.): ISDS provisions in Indonesian IIAs**

	ACIA	AANZFTA	ASEAN-China FTA	ASEAN-Korea FTA	Model BIT	Indonesia-Japan EPA	Other BITs
Fork-in-the-road	Yes (Article 34)	Yes (Article 22)	Yes (paragraph 5, 6)	Yes (paragraph 6)			Rare
Submission of claim	Specification of institutions and procedures (Article 33)	Specification of institutions and procedures (Article 21)	Specification of institutions (paragraph 4)	Specification of institutions (paragraph 5)	Specification of institutions (paragraphs 2, 3)	Specification of institutions and procedures (paragraphs 4, 6, 7)	Specification of institutions very common
Selection of arbitrators	Detailed procedures (Article 35)	Detailed procedures (Article 23)				Detailed procedures (paragraphs 10, 11, 12)	
Conduct of arbitration	Detailed procedures (Articles 36, 40)	Detailed procedures (Articles 25, 27)				Yes (paragraphs 14, 15)	

<b>Table 7 (cont.): ISDS provisions in Indonesian IIAs</b>							
	<b>ACIA</b>	<b>AANZFTA</b>	<b>ASEAN-China FTA</b>	<b>ASEAN-Korea FTA</b>	<b>Model BIT</b>	<b>Indonesia-Japan EPA</b>	<b>Other BITs</b>
Interim measures	Yes (Article 34)	Yes (paragraph 22)	Yes (paragraph 7)	Yes (paragraph 12)		Yes (paragraphs 9, 17)	
Consolidation of claims	Yes (Article 37)	Yes (Article 24)					
Expert reports	Yes (Article 38)					Yes (paragraph 16)	
Transparency	Yes (Article 39)	Yes (Article 26)					
Awards	Detailed provisions (Article 41)	Detailed provisions (Article 28)		Brief provisions (paragraph 14)		Detailed provisions (paragraphs 18, 19)	Rare
Source: Authors							

### 3.4.10 Investment facilitation and promotion

Out of all Indonesian IIAs, only the ACIA of 2009 and the ASEAN-China FTA of 2009 have explicit investment promotion provisions.<sup>142</sup> The areas related to promotion covered in both of these agreements include organising events, meetings and exchanges to promote investments and to inform about relevant laws and regulations; creating a positive investment environment; and simplifying rules and regulations, which includes disseminating information on the regulatory environment. The ACIA of 2009 advocates the promotion of certain companies (especially SMEs) and activities (in particular the enhancement of business networks).<sup>143</sup>

In terms of the establishment of institutions that could, among other functions, support the promotion of investments, Indonesia recommends in most of its IIAs that consultations can be held at any time between the parties of an agreement.<sup>144</sup> However, such provisions, when found in Indonesia's BITs, do not resemble efforts of investment promotion, as no institutional framework is set up that involves regular meetings and discussions on promotion issues. Only the more elaborately crafted ASEAN agreements and the Indonesia-Japan EPA of 2007 provide for such institutional arrangements.<sup>145</sup> But even in these agreements, promotion is not explicitly stated as one of the objectives of the institutions and committees to be established; nevertheless, these provisions allow for the possibility to consult on other matters or additional functions, which could potentially include promotion. In general, these institutions and committees are useful, as they enable a better exchange of information and may also function as a useful conduit of communication about potential investor-state disputes. Finally, subrogation clauses are very common in Indonesian IIAs.

Domestically, investment facilitation features strongly in Indonesian Law No. 25/2007 concerning Investment. Such investment "facilities" can be provided by government to investors for the expansion or establishment of

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142 ACIA of 2009, Articles 24, 25 and 26; ASEAN-China FTA, Articles 20 and 21.

143 ACIA of 2009, Article 24.

144 These provisions usually provide that the agreement can be amended at any time based on mutual consent of the parties.

145 ACIA of 2009, Articles 42 and 43; AANZFTA of 2009, Article 17; ASEAN-China FTA of 2009, Article 22; and ASEAN-Korea FTA, Articles 24 and 26; Indonesia-Japan EPA of 2007, Article 75.

investments. There are specific development-oriented criteria that have to be met to qualify for facilities. These include: large-scale employment of workers, infrastructure development, transfer of technology, partnering with SMEs, investing in remote regions, conducting research and development, being in a new industry etc. Such facilities are usually provided in the form of tax and fiscal incentives.<sup>146</sup> The goal is to address Indonesia's specific problems such as technological deficiencies (through the creation of backward and forward linkages with investors in key industries), the need for improvements in particular sectors, the need for promotion of pioneer industries and strong differences between regions in terms of economic development and attractiveness for investment.<sup>147</sup> It is further clarified that facilities are given on the basis of Indonesia's industrial policy.<sup>148</sup> The Masterplan, with its promotion of infrastructure investment, fits with this policy.

In Law No. 25/2007, the BKPM is given the task of undertaking investment promotion.<sup>149</sup> The BKPM functions as Indonesia's official IPA, and it is known to be active and successful in the area of investment promotion, with its worldwide marketing of "remarkable" Indonesia through brochures, video commercials and other means. An expanding network of Indonesia Investment Promotion Centres overseas and other representative offices of Indonesia in other countries is used to provide information and advice on Indonesia as an investment location.<sup>150</sup> In addition to investor- and project targeting, the BKPM's current programme also includes assistance during the establishment phase and aftercare services (APEC 2010). These activities include assisting investors in solving problems, for example when there are conflicts with particular government agencies or regional governments.<sup>151</sup>

The previously mentioned administrative efforts to reduce red tape in the establishment process, including the implementation of PTSP and National

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146 Law No. 25/2007, Article 18. This law has more incentives than its predecessor.

147 According to the accounts of several experts. A large majority of foreign investment in Indonesia is actually made in Java and Sumatra (OECD 2010), as investors are quite unwilling to invest elsewhere in Indonesia. This is in part due to infrastructure and energy bottlenecks – a problem currently being addressed in Indonesia's various development plans (see above).

148 Law No. 25/2007, Article 20.

149 Law No. 25/2007, Article 28.

150 See BKPM Regulation No. 9/2009.

151 According to one expert.



Single Window for Investment, also function as investment promotion through the improvement of the investment environment. Government efforts to harmonise legislation, and indeed the creation of Law No. 25/2007 concerning Investment as an interlocking law that is investment-specific, also help improve the transparency of the regulatory framework on investment, thereby promoting investment.

The relevant taxation regulations are found in Government Regulation No. 1/2007 concerning Facility of Income Tax on Capital Investment in Certain Business Lines and/or Certain Regions,<sup>152</sup> which has been amended by Government Regulation of the Republic of Indonesia Number 62 of 2008 concerning Amendment to Government Regulation Number 1 of 2007 concerning Income Tax Facility for Investment in Certain Business Fields and/or Certain Regions.<sup>153</sup> The incentives in these regulations are in line with the facilities outlined in Law No. 25/2007, granting various tax allowances in labour-intensive industries, sectors that require technology transfer, natural resource industries etc., in line with industrial policy priorities (OECD 2010, 97). At the time of research, Government Regulation No. 52/2011 was the main regulation for tax incentives, including lowered company income tax and accelerated depreciation and amortisation. In addition, there is a list of specific incentives for more than 50 sectors, for investment in special regions, and for particular corporations and cooperatives.<sup>154</sup> One purpose of this incentive scheme is to attract direct investment; it is possible that the recent increases in direct investments are partially a result of such policies.

Indonesia also provides incentives by reducing customs duties or providing waivers on the payment of customs duties for investments meeting certain specified requirements that have a positive effect on development. According to the Regulation of the Finance Minister Number 176/PMK.011/2009 on the Exemption from Import Duty on the Imports of Machines, Goods and Materials for the Establishment or Development of Industry in the Frame of Investment, certain kinds of imports of machines, goods, components and materials used to produce finished goods are exempted from customs

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152 See, in particular, Article 2.

153 There are continuous implementing regulations, such as Regulation No. 52/2011. See [http://www.lowtax.net/asp/story/front/Indonesia\\_Extends\\_Tax\\_Incentives\\_\\_\\_\\_53349.html](http://www.lowtax.net/asp/story/front/Indonesia_Extends_Tax_Incentives____53349.html) (accessed 25 Oct. 2012); [http://www.makarim.com/news/LegalUpdates\\_item.asp?modID=267](http://www.makarim.com/news/LegalUpdates_item.asp?modID=267) (accessed 25 Sept. 2012).

154 According to one expert.

duties for a specified period of time if they are not produced in Indonesia or if Indonesian products do not meet the necessary qualitative or quantitative specifications. Companies that are diversifying or expanding their capacity by a specified amount will also be exempt from import duties.<sup>155</sup> As stated in the preamble of this regulation, the object is clearly development-oriented:

*in order to increase domestic investment to strengthen the national economy which faces the global competition, it is necessary to grant an exemption from import duty on the imports of machines, goods and materials for the establishment or development of industry in the frame of investment.*<sup>156</sup>

In more general terms, this is also specified in Law No. 17/2006 regarding Amendment to Law No. 10/1995 on Customs. Finally, Law No. 25/2007 also provides for selected services and support in the area of import licensing.<sup>157</sup>

In addition, Indonesia is making efforts to attract more investors by establishing special economic zones. Law No. 25/2007 clarifies that such zones should be established strategically with the economic development considerations of relevant regions in mind. Investment policy in these zones can be different from elsewhere.<sup>158</sup> Law No. 39/2009 on Special Economic Zones enables zones covering large areas to exploit scale economies and encourage various kinds of economic activities (APEC 2010). Many zones targeting more remote regions of Indonesia are still in the process of being considered. There are also several specified free trade zones and ports, and bonded zones, where companies benefit from various tax- and other incentives, including reduced export and import tariffs – or none at all.<sup>159</sup> One such zone is the Batam Free Port and Free Trade Zone across from Singapore.<sup>160</sup>

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155 Regulation of the Finance Minister Number 176/PMK.011/2009, Articles 2 and 4. According to Article 6, motor vehicle industries are not eligible for these benefits, except for component industries in this sector. See also Ministry of Finance Decree No. 154.

156 Regulation of the Finance Minister Number 176/PMK.011/2009, preamble.

157 Law No. 25/2007, Article 24. There are a variety of laws issued by the Ministry of Trade regulating imports. An illustration of the complexity of the matter can be found in Renti and Helmholz (2012).

158 Law No. 25/2007 concerning Investment, Article 31.

159 According to comments made by two experts.

160 Government Regulation of the Republic of Indonesia No. 46/2007 on Batam Free Port and Free Trade Zone.

This section has shown that the government has quite a lot of flexibility to facilitate and promote investment in areas that it considers important for development. Investment promotion and incentives are treated much more elaborately in domestic laws and regulations, and are not made into a commitment at the international level within IIAs. One disadvantage of providing facilities to investors is the burden on the government budget, and it is important to always review the costs of incentives against the benefits obtained from them. Accordingly, the Indonesian government frequently reviews whether fiscal incentives meet their intended objectives such as attracting investments; past experience in Indonesia has shown that tax incentives can be ineffective in promoting investment (OECD 2010, 196–197). More generally, further research is needed on the extent to which the desired companies actually invest as a result of such promotion efforts.

### 3.4.11 Investor obligations

As mentioned above, Indonesian IIAs tend to require investments to be made in line with the host country's laws and regulations. Other than that, there are no specific clauses dealing with investor obligations, except for a requirement in the ACIA of 2009 for the disclosure of information in certain circumstances.<sup>161</sup> Indonesian IIAs include exceptions for taxation matters in various provisions, especially within the MFN clause, providing the necessary flexibility for national law to determine the appropriate levels of taxation. Only the ACIA of 2009, the AANZFTA of 2009 and the ASEAN-Korea FTA include provisions on performance requirements, which are to be in line with the Agreement on Trade-related Investment Measures (TRIMs) under the WTO. By not having more provisions on performance requirements, Indonesia might retain some legislative flexibility in certain policy areas such as local content or technology transfer.

Contrary to this absence of provisions on investor obligations in IIAs, Indonesian national law has quite a few relevant clauses. Article 10 of Law No. 25/2007 concerning Investment specifies requirements to prioritise the employment of Indonesian workers, to improve the capabilities of Indonesian staff through trainings and to transfer technology.<sup>162</sup> Requirements beyond

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161 ACIA of 2009, Article 20.

162 Law No. 25/2007, Article 10.

manpower issues are spelt out elsewhere in the law. Investors are required to manage their company in an appropriate manner, adhere to the principles of social responsibility, respect the cultures of Indonesian communities and comply with the rules of law.<sup>163</sup> If these latter requirements are not adhered to, companies may be sanctioned through administrative warnings; restrictions or suspensions to their business; or revocation of their investment facilities or rights to do business. Other kinds of punishments are also possible.<sup>164</sup> Further liabilities of investors are specified, which include, among other things, a responsibility to preserve the environment and treat workers appropriately.<sup>165</sup> This is in line with a general move in Indonesia to promote principles of responsible business conduct (OECD 2010, 209).

So far, Indonesia has not properly enforced the obligations in this area by detailing implementation procedures, clarifying reporting requirements and determining the level of sanctions (OECD 2010, 218, 221). Nevertheless, specification of these obligations in the form of a law may be useful as an avenue to inform companies on the intent and desire of the government, indicating that government regulations and presidential decrees may follow if appropriate action is not taken voluntarily by companies.<sup>166</sup> One example where enforcement is observable can be found in Law No. 40/2007 concerning Limited Liability Companies on the issue of “environmental and social responsibility”.<sup>167</sup> The law requires assessments of company performance on environmental and social responsibilities in their annual reports. Environmental and social responsibility is particularly required in the natural resources sector, where companies are asked to budget and calculate relevant costs.<sup>168</sup> Article 95 of Law No. 4/2009 concerning Mineral and Coal Mining specifies that holders of mining permits must apply good mining techniques in line with respective principles, develop and empower the local community and mine at environmentally tolerable levels. The law gives concrete advice on what companies should do in these areas, such as the preparation of development and empowerment plans for local communities and an environmental impact assessment (known as an

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163 Law No. 25/2007, Article 15.

164 Law No. 25/2007, Articles 33 and 34.

165 Law No. 25/2007, Articles 16 and 17.

166 According to the views of two experts.

167 Law No. 40/2007, Articles 1 and 74.

168 Law No. 40/2007, Articles 66 and 74.

*analisisdampaklingkungan* or AMDAL). Preference should also be given to employment of local workers and procurement of domestic goods and services.<sup>169</sup> More broadly, environmental protection and management is promulgated by Law No. 32/2009 concerning Environmental Management (OECD 2010, 211).

In certain industries, especially sensitive sectors, Indonesia still establishes performance requirements for investors. These include local content requirements in sectors such as machinery, electronics and automobiles, in line with a strategy of import substitution. There are also some domestic market obligations imposed in industries such as coal, oil, gas, mining and food, in order to ensure domestic availability of these resources (APEC 2010).

Paying taxes can be considered an obligation of the investor, and as with any country, Indonesia has its own set of taxation laws. The Law of the Republic of Indonesia Number 26 of 2008 concerning the Fourth Amendment of Law No. 7/1983 concerning Income Tax was enacted in line with Law No. 25/2007 and reduced corporate tax rates. Taxation differs between residents and non-residents. Residents, that is, companies incorporated or domiciled in Indonesia, have their global incomes taxed, whereas non-residents are taxed only on their Indonesian income (OECD 2010, 195). A foreign company classified as “permanent establishment” is taxed similarly or equally to domestic companies. Indonesia has concluded tax treaties with at least 59 countries and jurisdictions (APEC 2010).<sup>170</sup>

Customs duties on imports or exports are a different kind of investor obligation, which, apart from the incentive schemes mentioned above, also apply to foreign investors in Indonesia. Law No. 17/2006 regarding Amendment to Law No. 10/1995 on Customs regulates customs issues in

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<sup>169</sup> Law No. 4/2009, Articles 95, 39, 106, and other articles.

<sup>170</sup> The partner countries of Indonesian tax treaties are: Algeria, Australia, Austria, Bangladesh, Belgium, Brunei Darussalam, Bulgaria, Canada, China, Czech Republic, Denmark, Egypt, Finland, France, Germany, Hungary, India, Italy, Japan, Jordan, Korea DPR, Republic of Korea, Kuwait, Luxemburg, Malaysia, Mexico, Mongolia, the Netherlands, New Zealand, Norway, Pakistan, the Philippines, Poland, Portugal, Qatar, Romania, Russia, Saudi Arabia, Seychelles, Singapore, Slovakia, South Africa, Spain, Sri Lanka, Sudan, Sweden, Switzerland, Syria, Chinese Taipei, Thailand, Tunisia, Turkey, Ukraine, United Arab Emirates, the United Kingdom, the United States of America, Uzbekistan, Venezuela and Vietnam (APEC 2010).

Indonesia. Customs duties are specified in the Indonesian Customs Tariff Book.

It can be concluded from this that Indonesia has maintained some policy space in order to enact various kinds of investor obligations into law. The limited number of commitments in IIAs on performance requirements and the common use of taxation exceptions are largely in accordance with such regulatory flexibility. National laws and international commitments appear to be mostly coherent. The Indonesian government seems to be showing interest in enhancing the amount of investor obligations, with development objectives in mind, but remains cautious because such obligations could also deter investors. We can therefore observe that the Indonesian government has recognised the importance of keeping a balance between attracting investments and imposing obligations on investors in view of development goals. Investor obligations should be non-discriminatory in nature.

### 3.4.12 Scope and exceptions

Several ASEAN IIAs limit treaty coverage to investments established after entry into force of the treaty.<sup>171</sup> However, any BITs previously concluded by ASEAN countries would remain in force to the extent that they cover older investments. Indeed, most Indonesian BITs cover investments made both prior and after the date of entry into force, taking a broad approach in terms of coverage. In rare occasions, disputes emerging prior to the entry into force of the agreement are excluded, reducing liability of the state.<sup>172</sup> In most Indonesian IIAs, investors are allowed to maintain their rights under the agreement for more than 10 years after an agreement was terminated.

Reference is made to Indonesian Law No. 1/1967, the predecessor of Law No. 25/2007 concerning Investment, in practically all IIAs except for some recently concluded ones such as the ASEAN agreements.<sup>173</sup> Indonesia, hence, provides an explicit reference to its domestic investment law in each IIA, and explicitly states that protection and coverage under the treaty only

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171 ACIA of 2009; ASEAN-Australia-New Zealand FTA, Article 2; ASEAN-Korea FTA, Article 1.

172 e.g. Indonesia-Mozambique BIT of 1999; Indonesia-Romania BIT of 1997; Indonesia-Singapore BIT of 2005; Indonesia-Thailand BIT of 1998; Indonesia-Turkey BIT of 1997.

173 See also Indonesia-Germany BIT of 2003; Indonesia-India BIT of 1999; Indonesia-Singapore BIT of 2005.

applies to those investments established in accordance with this law or any subsequent law that replaces it. The Indonesia-Vietnam BIT of 1991 further specifies that investments must have been approved in order to be protected by the treaty.

As shown in Table 8, exceptions and reservations are only included in the pre-establishment IIAs formed within ASEAN and between Indonesia and Japan, that is, those agreements following the liberalisation approach. Because pre-establishment treaties lead to liberalisation of the host state's investment regime, it is necessary to specify more clearly each non-conforming measure in an annex. Accordingly, Indonesia's pre-establishment treaties allow for some non-conforming measures with regard to individual provisions (such as national treatment or expropriation). There is the expectation that such non-conforming measures – specified further in long annexes to the agreements – should be phased out over time, implying efforts towards further liberalisation. Meanwhile, with the notable exception of a short clause in Article 12 of the Indonesia-India BIT of 2009, there are no such clauses in the post-establishment BITs or the Indonesian model BIT that follow the protection approach. It is worth noting in this context that the ACIA of 2009 applies only to the following sectors:

*(a) manufacturing; (b) agriculture; (c) fishery; (d) forestry; (e) mining and quarrying; (f) services incidental to manufacturing, agriculture, fishery, forestry, mining and quarrying; and (g) any other sectors, as may be agreed upon by all Member States.*<sup>174</sup>

In domestic law, each law has its own specific temporal scope. Law No. 25/2007, as most other laws, is valid from the date of its enactment. The previous laws of 1967 and 1968 then became invalid, though some implementing regulations that were based on them would still continue to be in force.<sup>175</sup> There is little indication in domestic law about general exceptions.

Indonesian national law applies to any investments in any sectors.<sup>176</sup> At the same time, Indonesian national law declares certain business sectors to be partially or fully closed to investment if so determined by the government. This will be done in line with national interests. Sectors can be fully closed

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174 ACIA of 2009, Article 3, paragraph 3.

175 Law No. 25/2007, Articles 37, 38 and 40.

176 Law of the Republic of Indonesia No. 25/2007 concerning Investment, Article 2.

<b>Table 8: Exceptions and reservations in Indonesian IIAs</b>					
	<b>ACIA of 2009</b>	<b>AANZFTA of 2009</b>	<b>ASEAN-China FTA of 2009</b>	<b>ASEAN-Korea FTA</b>	<b>Indonesia-Japan EPA of 2007</b>
Balance-of-payments exception	Article 16	Chapter 15, Article 4	Article 11	Article 11	Article 70
Prudential measures					Article 71
National security exception	Article 18: Self-judging	Chapter 15, Article 2: Self-judging	Article 17	Article 21	
Public morals and public order	Article 17		Article 16	Article 20	
Human, animal or plant life or health	Article 17		Article 16	Article 20	
Taxation	Article 17	Chapter 15, Article 3	Article 3, paragraph 4	Article 2	
Protection of national treasures	Article 17		Article 16	Article 20	
Conservation of natural resources	Article 17		Article 16	Article 20	
Government procurement		Chapter 11, Article 1	Article 3, paragraph 4	Article 2	
Subsidies or grants		Chapter 11, Article 1	Article 3, paragraph 4	Article 2	
Government services		Chapter 11, Article 1	Article 3, paragraph 4		
Trade in services measures			Article 3, paragraph 4		

Source: Authors



because of issues such as “*health, moral, culture, environment, national defense & security*.”<sup>177</sup> Sectors can be partially closed if certain conditions or criteria are met, including

*protection of natural resources, protection of micro, small, and medium business, as well as cooperatives, supervision of production and distribution, increase of technological capacity, participation of domestic capital, and joint venture with companies appointed by the government.*<sup>178</sup>

Keeping certain sectors of the economy fully or partially closed to foreign investors can help enhance policy flexibility to pursue development objectives. Indonesia’s policies to allow only partial ownership in sectors where SMEs are omnipresent<sup>179</sup> and to encourage spillovers through joint ventures and technology transfer are clearly geared towards enhancing the development impact of FDI. Keeping sectors closed is in line with admission clauses in BITs, as approval can be denied, but it has to be reflected in the schedules to the ASEAN agreements and the Indonesia-Japan EPA.

Indonesia provides a negative list that is continuously updated and has been recently streamlined in line with the commitments made under ASEAN. The list specifies which sectors are fully closed to investors and which foreign investors face limitations in equity ownership. The negative list can currently be found in Presidential Regulation of the Republic of Indonesia Number 36 of 2010 on List of Business Fields Closed to Investment and Business Fields Open, with Conditions, to Investment. A variety of considerations were made in preparing this list, including local content and local employment in certain sectors in line with an import substitution strategy, and domestic market obligations geared, for example, towards guaranteeing the availability of specific energy resources domestically (APEC 2010). Joint venture requirements are also found in the negative list (Eurocham 2011, 35). The negative list has been considered to be rather extensive by international standards, though this may be due to its high level of transparency (OECD 2010, 76). It is possible to take sectors off the negative list, but also to add sectors, as happened with telecommunication towers in 2008 (OECD 2010, 135). Presidential Regulation of the Republic of Indonesia Number 76 of 2007 regarding the Criteria and Establishment of Closed Business Line and Open Business with Conditions in Respect of

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177 Ibid., Article 12, paragraph (3).

178 Ibid., Article 12, paragraph (5).

179 Article 13 of Law No. 25/2007 further elaborates on the issue of cooperation with SMEs.

Capital Investment specifies the criteria for closing sectors partially or fully to investment, which are consistent to those specified in Law No. 25/2007 (see above). Article 17 of Presidential Regulation No. 76/2007 provides that the negative list shall be evaluated regularly and revised in accordance with national interests and in view of Indonesia's economic development.<sup>180</sup>

The Coordinating Ministry for Economic Affairs has overall responsibility for the negative list, accepting requests from other agencies for the inclusion of certain sectors on the list.<sup>181</sup> The preparation of the negative list is also informed by stakeholder consultations.<sup>182</sup> Presidential Regulation No. 76/2007 further emphasises that compliance with international commitments and international agreements has to be maintained.<sup>183</sup> Other relevant laws are Law No. 25/1992 on Cooperatives, Law No. 20/2008 on Micro, Small and Medium Enterprises, and Government Regulation No. 44/2007 on Partnership. All this is in line with Article 33, paragraph (2) of the Indonesian Constitution, which states that *“sectors of production which are important for the country and affect the life of the people shall be under the powers of the State.”*

The legal changes made since 2007, especially the changes to the negative list, have opened up previously restricted sectors to foreign investment (OECD 2010, 45). Because it is a negative list and not a positive list like before, Indonesia portrays itself as generally open for investments. At the same time, confusion persists about the direction and consistency of Indonesian investment policy, in particular regarding the future of the negative list. Although Indonesia appears to make use of its policy space to partially or fully close certain sectors to investment, it is less evident whether the negative list accurately reflects Indonesia's economic development needs, and to what extent other concerns and stakeholder interests might have played a role in the development of the list. Quite certainly, some policies – such as those that protect SMEs, which constitute the large majority of firms in Indonesia – do appear to make a development contribution.

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180 Presidential Regulation No. 76/2007, Article 5.

181 Presidential Regulation No. 76/2007.

182 According to one expert.

183 Presidential Regulation No. 76/2007, Article 6, paragraph (2).

### 3.5 Recent Indonesian measures affecting investment

In order to examine how the nature of the international and national legal framework on investment relates to recent policy-making, this section briefly surveys regulatory changes between 2008 and 2011, and then discusses in greater detail selected policy developments that have a particularly significant impact on investors. Table 9 lists the most recent major national measures taken in Indonesia that affect investments.<sup>184</sup> What becomes immediately apparent is that Indonesia has undertaken a large number of policy measures that are in line with its continuous reform efforts and in order to adapt national policy measures to changing conditions. Some measures are favourable to investments, whereas others seek to restrict investment; many of them – both favourable and restricting ones – appear to have been introduced with particular development objectives in mind. But to a certain extent, it seems that Indonesia is making too many changes in national policy.

Some of the measures exhibit a particular concern with issues of ownership and control, and laws regulating divestment are not uncommon. Equity restrictions on foreign investment are very common in Indonesia (OECD 2010, 33). In accordance with this view, Indonesia ranked poorly in the OECD's FDI restrictiveness index. Indonesia was the third most-restrictive country among those analysed in the index for 2012, after China and Saudi Arabia.<sup>185</sup>

This mixture between favourable and restrictive investments reflects the aforementioned rift in the Indonesian discourse on economic policy between a more liberal approach and an approach that favours a strengthened industrial policy and government intervention. New measures not only target investments directly – other investment-related fields, such as trade, have also been affected by new measures. Among the recent policies in the trade field are a ban on exports of rattan and other products, and a limit on the ports through which imports of horticulture products can enter Indonesia (Haswidi 2012). If a trend can be discerned from these policy developments, it would point towards an increase of trade barriers. The

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184 The list is not intended to be exhaustive.

185 OECD, FDI Regulatory Restrictiveness Index, 2012; available at: <http://www.oecd.org/daf/internationalinvestment/investmentstatisticsandanalysis/ColumnChartImage%20%202012%20FDI%20RR%20Index.pdf> (accessed 28 Oct. 2012).

**Table 9: Recent regulatory changes affecting investors in Indonesia**

Date	Name of measure	Description of measure	Affected issue
2011	Tax holiday for major direct investors	A regulation for tax holidays will be issued immediately. Affected industries will be in mining, petroleum and gas industries, machinery, telecommunications and renewable resources. Tax holidays shall be granted to investments amounting to 1 trillion [Indonesian <i>rupiah</i> ] that are industry pioneers.	Investment facilitation
30 December 2010	Government Regulation No. 94/2010 (Calculation of taxable income and settlement of income tax)	Taxpayers making new investments in “pioneer” industries may receive an exemption or reduction of their corporate income tax. The term “pioneer” refers to activities involving high-value technologies that hold strategic importance for the national economy.	Investment facilitation
21 December 2010	Presidential Regulation No. 78/2010 (Infrastructure guarantee in public private partnership provided through infrastructure guarantee fund); Minister of Finance’s regulation no. 2/60/PMK.011/2010)	The government of Indonesia issued the regulations relating to the granting of infrastructure guarantees by the Indonesia Infrastructure Guarantee Fund. The aim is to improve the quality of the PPP projects and their creditworthiness through the provision of guarantees for government obligations in the PPP contracts.	Investment facilitation
24 November 2010	Law No. 13/2010 (Horticulture)	Foreign firms in horticulture will be limited to 30 per cent ownership. Firms that currently have more than 30 per cent will be required to divest to that level.	Admission

<b>Table 9 (cont.): Recent regulatory changes affecting investors in Indonesia</b>			
<b>Date</b>	<b>Name of measure</b>	<b>Description of measure</b>	<b>Affected issue</b>
01 February 2010	Government Regulation No. 23/2010 (Conduct of business on mineral and coal mining industry)	All existing mining licences shall be converted to the new form of mining business permit by 1 May 2010. The regulation also requires existing mining companies in the production stage to process or refine minerals in Indonesia within five years.	Admission Treatment
2010	Negative investment list (Presidential Regulation No. 36/2010)	Liberalisation of industries and sectors for investment, including cyclamate and saccharine industries, the construction industry, film and health service sectors, and electricity generation sector.	Admission
2010	Administrative reform programme	The Investment Coordinating Board of Indonesia is taking over the issuance of permits and licences from 15 other government departments to simplify and speed up bureaucratic procedures. In addition, a so-called One-Stop Shop (PTSP) for all business licensing procedures and an electronic (online) licensing and information service (SPIPISE) is to be introduced.	Admission
2010	Law No. 36 (Income tax)	The corporate tax rate was reduced from 28 per cent to 25 per cent flat rate. Public companies, which are subjected to a minimum share listing of 40 per cent and other conditions, are entitled to a 5 per cent tax discount off the normal rate.	Investor obligations

<b>Table 9 (cont.): Recent regulatory changes affecting investors in Indonesia</b>			
<b>Date</b>	<b>Name of measure</b>	<b>Description of measure</b>	<b>Affected issue</b>
31 December 2009	Ministerial decree on domestic coal market obligation	Producers of coal and other minerals are to provide a proportion of the annual output to the domestic market. The proportion is determined according to the estimated annual demand by potential domestic buyers a year earlier. Sanctions apply in case the agreed volume cannot be met.	Investor obligations
08 September 2009	Law No. 30/2009 (Electricity)	Private investors, including foreign investors, are allowed to generate, transmit, distribute and sell electricity. Hitherto, state electricity company PT Perusahaan Listrik Negara had a monopoly on supply and distribution of electricity to end-customers. State-owned enterprises retain the right of first priority to develop electric power projects.	Admission
2009	Law No. 4/2009 (Mineral and coal mining)	Abolishes the contract of work system for new foreign investment and sets forth a licence-based system. Mining projects will be permitted in areas designated as mining areas. Foreign investors can hold up to 100 per cent of a concession but must divest a portion of their shares in five years.	Admission, Investor obligations

**Table 9 (cont.): Recent regulatory changes affecting investors in Indonesia**

<b>Date</b>	<b>Name of measure</b>	<b>Description of measure</b>	<b>Affected issue</b>
2009	Postal service liberalization	New law on postal services abolishing monopoly power for certain postal services, and establishing specific conditions for foreign providers (for example, to cooperate with local service providers, a majority of equity participation in joint ventures should be Indonesian, and joint ventures between foreign and domestic providers limited to provincial capitals with international airports and seaports).	Admission
March 2008	Ministry of Communications decree	Closes the construction and ownership of wireless communications towers to all foreign investors.	Admission
2008	Shipping law of 2008	Provides the foundation for a comprehensive reform of the Indonesian port system. Most notably the law removes the state-sector monopoly on ports and opens the door for new participation by the private sector.	Admission
2008	Entry conditions for drug industry	Drug companies are required to have production facilities in the country in order to get licences to sell their products in Indonesia.	Admission
Source: UNCTAD database; support by UNCTAD is gratefully acknowledged			

aim of such measures is often to incentivise domestic production and value added, protect domestic industries and diversify domestic economic output by reducing the amount of imported parts and components.<sup>186</sup>

Regardless of whether the intention of such measures is nationalistic or developmental, there is a tendency to enact new laws and regulations but not follow them up sufficiently with implementing regulations (OECD 2010, 27). Another phenomenon is that new measures are readjusted not too long after their initial enactment in response to negative reactions by certain stakeholders or the public. Uncertainties are created as a result of these shifts and changes, potentially having a negative impact on investor confidence.<sup>187</sup> This seems to indicate that many regulations are not enacted on the basis of a thorough and careful assessment of possible consequences, but rather only on the basis of the government's views and procedures for decision-making. Crafting national measures with a lack of care could, however, have consequences at the international level if international commitments are not sufficiently taken into account in the process of drafting the measure.

With regard to national measures, particularly noteworthy and controversial developments have occurred in the mining sector, where a surge of restrictive measures have appeared recently. The Government Regulation of the Republic of Indonesia Number 24 of 2012 regarding Amendment of Government Regulation Number 23 of 2010 regarding Conduct of Business on Mineral and Coal Mining Industry has created unease about its impact on foreign investors.<sup>188</sup> In certain raw materials sectors, the law requires progressive divestment of foreign ownership in mining companies so that after a period of 10 years of production, an Indonesian government (central or local) or private entity will own at least 51 per cent of the company. Although such divestments are not new in Indonesia and have existed since the 1967 mining law, the magnitude of required divestments in Government Regulation No. 24/2012 is unusual. On the basis of the mining law issued

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186 According to the accounts of three experts.

187 According to the views of two experts.

188 See <http://de.scribd.com/doc/102518581/Government-Regulation-24-2012> and <http://portal.djmbp.esdm.go.id/sijh/PP%20Nomor%2024%20TAHUN%202012.pdf> (accessed 27 Oct. 2012).



in 2009<sup>189</sup> and a subsequent regulation in 2010,<sup>190</sup> the authorised foreign ownership ceiling was previously set at 80 per cent (OECD / UNCTAD 2012, 16; Butt / Nottage 2012). The 2009 Mining and Coal Law also places a ban on the exports of unprocessed minerals from 2014 onwards, forcing companies to process more of the minerals locally. Already at the time of research, restrictions on the export of unprocessed minerals had been put in place. One restriction is the requirement to obtain permission from the Ministry of Energy and Mineral Resources to be allowed to export; the other is an export tax of 20 per cent (Tampubolon 2012). The new legal framework on mining, established in 2009, gives priority to local mining service companies, shortens the duration of licences and favours local refining and processing (OECD 2010, 80).

For foreign mining companies, such divestment requirements could be problematic. In addition to the general uncertainty surrounding such regulations – potentially necessitating renegotiation of investment contracts – 10 years may not be considered sufficient to generate enough investment returns to make the investment viable. The length of time needed to make a profit differs within the mining sector (Mishkin / Thomas 2012). Government advice is also not clear on the issue of contract negotiation. In the past, companies had difficulties finding a government or Indonesian enterprise with sufficient funds to purchase the stake to be divested (Butt / Nottage 2012). Problems for investors could also result from the export ban, as the timeline may be too tight for some companies to make the necessary adjustments, technological and otherwise.<sup>191</sup>

It is debatable whether these measures in the mining sector should be considered as reflecting the Indonesian government's right to regulate. Only the future will determine to what extent such regulations might violate commitments made in an IIA, leading to an ISDS case. On one hand, admission clauses in investment treaties require that investments shall be made in accordance with Indonesian laws and regulations, which include this mining law, but on the other hand, the divestment requirement could be interpreted as a breach of a national treatment, expropriation or FET provision (Butt / Nottage / Williams 2012). It should be noted that many

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189 Mineral and Coal Mining Law No. 4/2009.

190 Government Regulation No. 23/2010. Divestment of at least 20 per cent was to occur within five years of operation (Harianto 2012).

191 According to the views of one expert.

“contract of work” agreements signed by foreign mining investments in Indonesia already require divestments up to 49 per cent of ownership, so there might not be that much changing as a result of the law (Bachelard 2012). Nevertheless, there are concerns that the law might be applied retroactively against investments that have been made under previous legal conditions.<sup>192</sup> The government is now pursuing renegotiations of contracts with investors, to include issues such as raising the amount of local processing in Indonesia, royalties, divestment and enhanced local content requirements (Tampubolon 2012).

Indonesia is still in need for foreign financial, technological and other kinds of assistance in the mining sector, especially in areas such as offshore extraction. Hence, one likely intention of the government for introducing such a regulation was to progressively reduce this dependence by fostering more local capabilities and participation in the mining industry and enabling more national companies to undertake exploration, exploitation and processing of natural resources in Indonesia. The hope would be that, by pushing for local production and divestment in the mining law, resulting spillover effects and technology transfer would generate more local economic value added in primary industries, enabling Indonesia to export more products with higher value added. An improved performance in that sector would be intended as the ultimate outcome.<sup>193</sup> Indonesian authorities have indeed mentioned that the encouragement of downstream metal refining and production within Indonesia was one objective of the barriers that were introduced (Nehru 2012). According to the mastermind behind the law, Dr Simon Sembiring, the mining law intended to follow the Indonesian Constitution, which states that minerals are owned by the people (Bachelard 2012). Article 33 of the Indonesian Constitution also requires that the state maintains control over the country’s natural resources.

However, this step towards less openness could deter foreign investors and businesses. In addition, doubts have been raised about the effectiveness of these policy measures. Local processing will require large amounts of capital and energy that are in short supply, and downstream industries might also be uncompetitive in Indonesia. Effects on raw material prices in Indonesia could be unfavourable, and there will be little employment

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192 According to one expert.

193 This discussion of the Indonesian mining sector and government intentions constitutes a summative account of the views of several experts in Indonesia.

generation as a result of local processing in the mining sector (Nehru 2012). As in the past, the mining industry forms an important part of the Indonesian economy today, contributing 17 per cent to Indonesian GDP and attracting a significant portion of FDI to Indonesia (Butt / Nottage 2012).<sup>194</sup> Given the importance of this sector to the national economy, caution is required *vis-à-vis* investment policy-making in this sector, and the government should make sure that any new measures taken are indeed conducive to the country's overall development goals.

The controversy over the mining law reflects the broader political debate about economic strategy that is currently being held in Indonesia. Part of this debate is also about how Indonesia should utilise and protect its natural resources.<sup>195</sup> To some extent, the mining law resembles an attempt by the Indonesian government to make use of its policy space and right to regulate. However, it is not certain whether making use of policy space in this specific context will have a more positive impact on economic development compared to previous policies. At the same time, such policy decisions enhance Indonesia's exposure to potential investor-state arbitration. Given the existing concerns about the new law, it is not unlikely that intense lobbying by interest groups and the business community could actually lead to adjustments to the mining law and relevant regulations. Unfortunately, the resulting lack of consistency and clarity would increase investor uncertainty about the legal environment in Indonesia.<sup>196</sup> In addition, it is of importance that the implementation of new measures goes hand in hand with enhancements of legal transparency and consistency.<sup>197</sup> It then becomes evident that making use of available policy space and the right to regulate can, in certain circumstances, be counterproductive.

Another question that emerges from the experience with the mining law concerns the way policy space should be utilised, whether through restrictions, as in the case of the mining law and the related export ban, or

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194 Indonesia's performance in attracting export-oriented FDI has been relatively weak (OECD 2010, 31).

195 According to the views of one expert.

196 According to the views of one expert.

197 Efforts in Indonesia to improve governance, including the reduction of corruption through initiatives such as the Law on Eradicating Corruption of 2001 and the establishment of a Corruption Eradication Commission in 2003 (OECD 2010, 26) are very important in this context.

through incentives (e.g. through tax benefits). The nature of the latter might be preferable from the point of view of attracting investments, but political interest groups have a tendency to advocate more restrictive approaches. More generally, an extensive feasibility analysis of all the consequences a restrictive law could have should be conducted prior to its enactment. As is discussed in more detail below, broad stakeholder consultations are a useful avenue to conduct such an analysis.

### 3.6 Policy coordination of international commitments with national law

This in-depth case study of Indonesia's investment law has demonstrated that the government is not short of capacity when it comes to issuing new laws and regulations, which happens with a relatively high degree of frequency. However, many of the laws lack implementing regulations, such as the CSR-related requirements in Law No. 25/2007 on Investment that have, for example, not found much obvious application in practice.<sup>198</sup> This discrepancy between law and practice may be a result of compromises being made in the process of inter-ministerial coordination during preparation of the law. Other measures, such as in the mining sector mentioned above, are being questioned or altered under pressure from the public or lobbyists. This, on the other hand, may be a result of insufficient prior stakeholder consultations.

Both inter-ministerial coordination and stakeholder consultations are important procedures during the process of preparing a new law in the field of investment. Inter-ministerial coordination ensures that laws governing investment matters are in conformity with other relevant laws and international commitments, while also taking particular concerns and interests of individual ministries into account. Stakeholder consultations are important, as they help assess whether the law is useful and effectively achieves desired outcomes. They help avoid controversies over a law and take various concerns and interests of all members of society into account already during the drafting stages of the law. Indonesia has been thorough in its approach to inter-ministerial coordination. At the same time, the intensity of stakeholder consultations could be further enhanced.

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198 According to one expert.

### 3.6.1 Inter-ministerial coordination

To ensure that international commitments are consistent with national laws, coordination among government ministries is vital. This is especially important in the field of international investment law, as IIAs entail far-reaching commitments that affect a broad set of domestic policy fields. In the field of investment law, inter-ministerial coordination helps ensure that no inconsistencies between bodies of law emerge that could eventually culminate in an international arbitration. Such coordination not only informs other ministries about new laws and regulations enacted and treaties concluded in the area of investment; it also allows ministries to influence national and international policy in the area of investment, as they might be substantially affected by any new laws and international treaties on investment, even if they are not directly responsible for such legislation. Achieving compromises among ministries is, of course, the major challenge in such processes, and an inability to compromise can seriously undermine efforts to establish a regime of international commitments that is in line with national laws. There are two types of inter-ministerial coordination: one involves coordination among the agencies of the central government, whereas the other involves relations between central and local governments.

Evidence from Indonesia suggests that coordination among government agencies in the area of investment is broadly implemented to the extent that formal linkages exist. In practice, however, coordination is still weak and does not always work. This is particularly the case in central-local relations, but can also be observed among ministries of the central government.<sup>199</sup> The government is still working on improvements in intergovernmental coordination among central government agencies and between central and regional governments (APEC 2010).

Institutional coordination on investment matters is sought through a variety of “coordinating agencies”. The most important one is the BKPM itself as a coordinating agency on investment matters. Its purpose is to coordinate with ministries in order to attract inward FDI to Indonesia. Individual agencies have authority over certain sectors of the economy, such as industry, energy or trade, and the BKPM coordinates the implementation of regulations on investment with them. The BKPM further arranges coordination of the

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<sup>199</sup> According to the accounts of numerous experts.

representative offices abroad with the Ministry of Trade.<sup>200</sup> The Coordinating Ministry for Economic Affairs coordinates larger policy issues, including the development of the Masterplan, but it is also involved in investment matters.<sup>201</sup> Its acting head, together with the president, functioned as head of the national team for export and investment (“PEPI”), an inter-ministerial body set up to promote export and investment through appropriate policy coordination. However, there were doubts about its actual performance and cost-effectiveness and lack of clarity about its institutional positioning.<sup>202</sup>

There are a few other agencies with coordinating functions relevant to investment. Bappenas, Indonesia’s planning and development agency, is a kind of think-tank ministry that specifies national policy, economic strategy and budgetary allocations and coordinates its decisions among ministries.<sup>203</sup> Bappenas also develops Indonesia’s five-year plans. The Ministry of Finance coordinates taxation matters with other ministries, including the BKPM, and concludes double taxation treaties. It also evaluates incentive schemes and other proposals in view of the government budget.<sup>204</sup>

Negotiations of trade and investment agreements also involve coordination among a variety of ministries and agencies, especially those dealing with economic matters, including the BKPM, the Coordinating Ministry for Economic Affairs, the Ministry of Trade, the Ministry of Industry and the Ministry of Foreign Affairs. The results of such inter-ministerial coordination, which can involve direct meetings among ministries, are then taken as the basis for international negotiations.<sup>205</sup> Accordingly, negotiation delegation can be made up of a mix of ministry staff, including from the BKPM, the Ministry of Foreign Affairs and the Ministry of Trade. Although the negotiator naturally has some discretion during the process of negotiations, the authority comes from prior consultations on policy among ministries. The parliament also has to be consulted during negotiations, as it is the body that has to discuss and eventually ratify treaties. And finally,

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200 According to the accounts of three experts.

201 According to the accounts of three experts.

202 See Kusnandar & Co. Solicitors, “To boost exports and invigorate investments”, 03 July 2013; online: <http://kusnandarlaw.blogspot.co.uk/2013/07/to-boost-export-and-invigorate.html> (accessed 02 Nov. 2013).

203 According to explanations made by two experts.

204 According to the explanations made by one expert.

205 Summative account based on comments made by three experts.

implementation of international commitments also has to be coordinated. Given that, in contexts such as ASEAN negotiations, each member state has its own concerns in domestic law and its own national interests, negotiations involve large amounts of international and national coordination.<sup>206</sup>

Despite many laudable efforts to coordinate among central agencies of the Indonesian government, coordination can be hampered by differences in views among ministries on appropriate economic policy. Some ministries have conflicting interests that can inhibit effective policy coordination and result in incoherent policies. This can complicate international negotiations, especially in complex forums such as ASEAN.<sup>207</sup>

The existence of particularly elaborate provisions on specific issue areas in Law No. 25/2007 suggests that the ministries responsible for these areas have been more closely involved in the process of developing the law. The special provisions on technology transfer, manpower, SMEs etc., reflect this. However, in practice, many of the requirements for technology transfer and employee training in Law No. 25 are not enforced or implemented.<sup>208</sup>

The implementation of the one-stop-shop system, based on Presidential Regulation No. 27/2009 (one-stop integrated services), is a case where coordination among ministries has worked well. More than 15 ministries had to agree to the system and give up their authority to approve business licences and provide related services in the sectors for which they are responsible (OECD 2010, 93). These steps of the regulatory process for investment were centralised in the BKPM, allowing the BKPM to implement the system both centrally and locally, with municipalities and regions establishing their own one-stop shops.<sup>209</sup> There is a tendency to move responsibilities for investment administration to the local level, whereas the BKPM refocuses more on investor services, policy formulation and coordination (OECD 2010, 32). The national single window as a continuation of this policy promises to further enhance these efforts towards coordination by automatising the licensing process.<sup>210</sup>

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206 Summative account based on comments made by three experts.

207 Summative account based on comments made by several experts.

208 According to the accounts of several experts.

209 According to one expert.

210 See <http://www4.bkpm.go.id/contents/general/16/ONE-STOP-SHOP>.

There is still a substantial need for more effective coordination between central and local governments. Greater regulatory decentralisation and shifting of competences to the local level<sup>211</sup> has led to policy divergence among regional governments, which tend to have their own autonomous policy approaches and laws in line with specific provincial contexts and development needs. Regional governments have individual interests such as generating more local income. Thus, some local governments tend to be more favourable towards foreign investment than others, while investors continue to have to deal with local governments during the process of investment. Regional autonomy has in some cases resulted in conflicting laws and regulations at the central and regional levels as well as disagreements between central and local governments over the distribution of authority. National laws imposed by the central government are often implemented differently by regional governments, and local governments are not always able to comply with laws and regulations issued by the central government.<sup>212</sup> In the worst cases, these differences can lead to ISDS cases.

Such problems are exacerbated by limited information provisions and mutual communication between the central and local levels. On one hand, regional governments might not always fully understand the larger implications of their regulatory decisions, including how they may impact on Indonesia's international commitments.<sup>213</sup> Capacities of local governments are naturally lower compared to the central government. The central government has recently been investing in capacity-building at the local level on investment matters (OECD 2010, 27–28, 171). On the other hand, the central government cannot always be fully informed about conditions at the local level, including what kind of development policy might be beneficial in particular local settings. Communication and exchange of information between central and local authorities is being enhanced to overcome these problems, despite the potentially high costs of such efforts.<sup>214</sup> The separation of responsibilities between central and local governments is being clarified; information about central government laws and regulations is provided through organised meetings; guidance on the enforcement of such laws and regulations locally is being provided; and learning and exchange among

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211 See Law on Regional Autonomy of 1999.

212 Summative account based on comments made by many experts.

213 According to one expert.

214 According to one expert.



local governments is being promoted (OECD 2010, 86, 96). Ensuring that local governments understand Indonesia's international commitments is an important part of this process.

Some efforts are now under way to limit some of the regional regulatory autonomy that has evolved in the past as part of the democratisation process. Hence, despite overall efforts towards decentralisation, there are numerous instances where the central government intervened in local regulatory activities. Continuous efforts are being made to harmonise the regulatory framework, thereby ensuring conformity between central and local regulations and among regional regulations, including in the area of investment (APEC 2010; OECD 2010, 65, 171).<sup>215</sup> Overall, this is a challenging process, but as long as these problems remain partially unresolved, the level of legal and business uncertainty for investors will remain elevated.

In sum, the issue of coordination has been recognised and broadly implemented in Indonesia. In fact, there may even be a tendency towards over-coordination in the central government, with a wide variety of coordinating agencies and ministries in place that deal with a multitude of related issues. This tendency towards over-coordination and overlap in coordination channels could also have, as a result, the counter-effect that coordination is less effective and becomes an unnecessary burden. It is possible that Indonesia has not yet found the most optimal approach to inter-ministerial coordination, resulting in weaknesses in the coordination process itself and making it harder to develop coherent policies through inter-ministerial procedures.

Even more challenging is the process of bringing together the results of such coordination with international commitments made in IIAs. International negotiations of investment treaties have to feed into the process of inter-ministerial coordination, and inter-ministerial coordination, in turn, must inform international negotiations. Only if the relevant processes are managed smoothly will domestic laws and regulations be in conformity with international obligations, reducing the likelihood of ISDS cases.

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215 See also Government Regulation No. 28/2007 on the Division of Roles between National, Provincial and Local Governments.

### 3.6.2 Stakeholder consultations

This study has repeatedly illuminated the complexities of managing the large variety of interacting laws and regulations on investment at the national and international levels. For governments, it is often a challenge to evaluate fully the impact and consequences of newly enacted laws and regulations. Thus, in order to avoid unnecessary controversies over new measures, it is important that governments consult not only among ministries, but also with all affected stakeholders about any new law or policy related to investment. Stakeholders include investors themselves and the business associations and chambers of commerce representing them, but also other firms, consumers, the public, civil society and non-governmental organisations. Whereas some stakeholders focus on business interests, others might be more concerned about the impact of investment on society and local communities. In addition to enabling governments to evaluate the possible consequences of new measures, stakeholder consultations allow for necessary adjustments to be made already before a new law enters into force, avoiding the potential need for corrections at a later stage. A likely result is an improvement in investor certainty, even when a government eventually does implement an unfavourable measure. In addition, consultations allow the government to explain its interests – and, in particular, its development objectives – and caucus among investors and other stakeholders about which kind of laws they think would be most suitable in view of these development considerations. In this way, even foreign investors will be involved in thinking about development issues and the role investment and investment rules can play.

To a certain extent, stakeholder consultations in the formulation of laws and regulations are compulsory in Indonesia, and according to Law No. 10/2004, the public has the legal right to be involved in the process. A procedure is in place whereby an inter-ministerial committee circulates a draft version of a legal text through the internet and the media, inviting comments and opinions. Accordingly, the business sector and civil society groups have contributed to Indonesia's recent efforts of regulatory reform in many policy areas, such as by providing analyses and recommendations (OECD 2010, 166, 169, 173).

In the area of investment, the Indonesian government also consults with a variety of stakeholders. Probably the most important contact points are business associations, with the Indonesian government and the BKPM engaging in consultations with domestic and foreign chambers of

commerce (OECD 2010, 30, 96). Of course, business associations such as the Indonesian Chamber of Commerce (KADIN) have a particular set of interests that they seek to promote, but at times these may be associated with development, such as when it comes to the question of how local enterprises and small businesses can effectively benefit from foreign investments and improve their technological capabilities. Sometimes investors are directly consulted, as happened, for example, in the preparation of Law No. 25/2007 concerning Investment and on other trade- and investment-related issues (OECD 2010, 28, 193). Other stakeholders consulted are trade unions and the Indonesian employers association. Foreign stakeholders are also consulted.<sup>216</sup> To further improve the system, domestic stakeholders should be involved in discussions about negotiations of international agreements, and existing consultations could be widened to involve a broader number of stakeholders.<sup>217</sup>

Moreover, foreign stakeholders are themselves getting actively involved through various channels. For example, the European Chamber of Commerce (EUROCHAM) in Indonesia maintains contact with the Indonesian government on investment issues. Such engagement by foreign stakeholders may sometimes be coordinated among different countries, and even with domestic stakeholders.<sup>218</sup>

To some extent, there is lack of evaluation of the possible consequences of new measures prior to their entry into force, as illustrated by a lack of formal regulatory impact assessments (OECD 2010, 172). An occurrence in 2007, where the new negative list had to be issued twice after complaints were made by the public sector (OECD 2010, 77), may serve as one example. The mining law may be another illustration of this. It is argued that the feasibility of new measures is not being examined in sufficient detail, so that possible consequences of these measures are not being contemplated and anticipated sufficiently. New measures may be enacted before consultations have taken place, so that public discussion of a measure only emerges upon enactment. If pressure by public stakeholders opposing (parts of) a new law builds up, the government may be induced to review the measure. The ultimate consequence may be a trial-and-error process of rule-making that

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216 According to one expert.

217 According to the views of two experts.

218 According to the explanations made by two experts.

increases legal uncertainty.<sup>219</sup> Similarly, new laws are often enacted without the necessary implementing regulations in place (OECD 2010, 27). There are two formal mechanisms in place to review laws. The first is a judicial review mechanism in which the constitutionality of laws can be reviewed by the Constitutional Court in accordance with Law No. 24/2003 on the Constitutional Court. The other, more common approach is in line with Law No. 10/2004, providing for a revision mechanism within the parliament (OECD 2010, 184).

A tentative conclusion is that broader communication and consultation efforts by the government with stakeholders, the public and investors form an important part of effectively making use of policy space and regulatory flexibility. Investors should understand that, at times, the government has reasons to issue measures that are unfavourable to them. But what matters is the way in which the measures are developed; a government planning new regulations should consult and communicate with stakeholders – including the investors themselves or their representatives – prior to enacting the measures. This will decrease uncertainty among investors and increase the level of transparency of the government’s policy considerations. Changing conditions, which are a natural result of poorly crafted policies that require revisions, can deter investors. No doubt that such a process of stakeholder consultations can be costly, in particular in terms of providing sufficient human resources. But if conducted effectively, stakeholder consultations could end up economising funds, as measures would be introduced and implemented more swiftly. Therefore, establishing consistent procedures for “negotiated rule-making” is useful for governments in the process of developing or revising a regulatory framework on investment, and such procedures should also be attached to the negotiation of investment treaties. Because they are affected by the new rules, investors and other stakeholders can often detect problems with laws, regulations and international commitments better than the government. This includes detection of legal inconsistencies between central and local, national and international, or investment-related and -specific bodies of law. Any feedback provided by stakeholders is information the government can use to harmonise and optimise rules and regulations, including in the interest of economic development.

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219 According to the explanations given by three experts.

## 4 What can be learnt from the Indonesian experience?

This study dealt with four interrelated questions. First, how national and international investment laws interact; second, whether national law forms the basis for international commitments made or *vice versa*; third, what governance mechanisms should be in place to ensure conformity of national and international investment laws; and fourth, what the implications are for policy space and economic development. In this section, we summarise the findings generated from the Indonesian case study. The final section then considers to what extent these specific findings generate valuable insights for international investment law and policy-making. Furthermore, we conclude with recommendations for further research and some lessons learnt for other developing countries.

### 4.1 A matter of complexity

The international system of IIAs is complex in and of itself, and adding domestic investment-specific as well as investment-related laws and regulations as an additional layer multiplies this level of complexity. The Indonesian case offers two interesting solutions to deal with this complexity: first, the introduction of an interlocking law increases the coherence between international and national investment law; and second, a hedging strategy by including references to domestic laws and regulations in Indonesian IIAs.

In section 3.4 of this study, we provided a juxtaposition of international commitments and investment-specific and -related national investment laws. Table 6 in particular can be utilised as an analytical template for an illustration of the interaction between the two bodies of law. The challenge of complexity becomes immediately apparent in this table and has been highlighted repeatedly within many sections of this study. It appears that the multitude of bodies of relevant law makes the system unmanageable.

In fact, in comparative terms, the international system appears structurally quite well-organised, even if negotiated commitments towards individual treaty partners in IIAs often differ substantially in content. The system is well-organised because most IIAs include the same types of provisions, or “core elements” (UNCTAD 2008a), such as definition of investment, FET, national treatment, MFN treatment, transfer of funds, expropriation and dispute settlement. Only the details of such provisions – plus some additional

provisions such as general exceptions, transparency rules and sustainable development provisions – are responsible for the differences between these agreements. In the domestic system, however, investment-related issues are dealt with in a variety of bodies of law, including the Constitution; financial regulations; competition, trade, labour and human rights laws etc. The challenge is to bring this variety of laws and legal regulations into conformity with each other, with investment-specific laws and with the set of international commitments on investment that are organised in structure, but varying in content.

One particular source of such complexity may be differences in the time frames within which the IIA regime and national policies seem to operate. A country's industrial policy may be in constant flux, in line with short- to medium-term economic trends and developments, though possibly with long-term goals in view. However, once concluded and ratified, IIAs are not easily changed and adapted; hence, they have a long-term dimension. It is important that governments nevertheless coordinate these two policy regimes sufficiently well, so that no significant problems emerge.

The overall challenge to ensure formal consistency and coherence is immense. One approach taken by Indonesia is to use an interlocking law that functions as an interface between international commitments and national law. This law is structured along the lines of IIAs, while attempting to combine the relevant issues of a large set of national laws into one legal text. The interlocking law, originally enacted in the late 1960s, has been revised once in 2007, creating Law No. 25/2007 concerning Investment. The interlocking law is effective in dealing with complexity and making investment law in Indonesia more transparent, although the system still remains incredibly complicated. At the same time, the interlocking law functions as an intermediary where national and international laws “meet”. It reflects compromises that have been reached and is indicative of areas where policy space has been negotiated.

The additional clarity and oversight provided by an interlocking law can also help achieve consistency between international commitments and domestic investment laws, although there is no guarantee that this will always be the case. This study's in-depth examination of the interaction between international commitments and national law has shown that there are instances where both appear to be coherent, whereas at other points, divergence is quite common. The extent to which this divergence between

international commitments and national laws is serious and could lead to investor-state disputes is hard to predict, but it is safe to argue that some degree of incoherence is unlikely to be harmful.

Nevertheless, Indonesia has developed a hedging strategy in addition to the use of an interlocking law. The detailed mapping and examination of Indonesian IIAs in this study has shown that references to domestic laws and regulations in Indonesian IIAs are much more common than might have been expected, in view of the global IIA practice. References to domestic laws and regulations have been found in sections of Indonesian IIAs dealing with the definitions, admission, FET, national treatment, expropriation, transfer of funds, foreign personnel, ISDS and scope. Whereas such references are only found in some – or even just a few – IIAs in areas such as FET, national treatment, expropriation, transfer of funds, foreign personnel and ISDS, they are almost omnipresent in provisions dealing with the definitions, admission and scope. Indonesia even includes a standard provision in most of its BITs that refers to its domestic interlocking law to establish applicability of the agreement. It is difficult to judge the legal significance of such references to domestic laws and regulations, but it is clearly a strategy to hedge against risks and to elevate the standing of Indonesian national laws whilst taking on international commitments.

## 4.2 Direction of interaction

This study found evidence that the direction of interaction between Indonesia's international commitments on investment and its national laws in this area is bi-directional. This in itself is an important finding, as the negotiation of IIAs often has been rather detached from the evolution of national investment law and the broader policy goals formulated by governments of developing countries (Poulsen 2014; Poulsen / Aisbett 2013). Traditionally, the negotiation of IIAs can be described as a one-way street where developing countries had to act as “price-takers” accepting the models put forward by industrialised countries (Elkins / Guzmán / Simmons 2006).

That Indonesia is not a mere price-taker is evident. First, the procedures of inter-ministerial and stakeholder consultations practised in Indonesia suggest that international negotiations are informed by the outcome of such consultations. Negotiators are constrained by the requirements formulated

by domestic institutions. Second, Indonesia has for a long time used its own model BIT as a basis for its negotiations of IIAs, which include, as a unique feature, reference to the Indonesian interlocking law. Thirdly, domestic agencies and institutions have some power to “push back” against some issues being negotiated at the international level. As a minimum, they can lobby for the inclusion of certain industrial sectors or activities on the negative list and in the schedules of Indonesia’s treaties. More powerful agencies might also succeed in mandating the inclusion of some safeguards or require the addition of specific provisions in domestic law. Fourthly, as is discussed in further detail below, there has been some flexibility in the way international commitments are implemented and enforced in Indonesia. And finally, internationally negotiated commitments have to be ratified domestically by parliament, providing a domestic entity with ultimate discretion on the decision to adopt an internationally negotiated text.

Despite the above, international rules and commitments do impact on the nature and content of national laws and regulations. Firstly, the organisation of the Indonesian interlocking law is very similar to that of an IIA, suggesting that elements of an international legal text have been at least partially adopted into national law, both in terms of structure as well as content. Most notably, the newest version of the interlocking law, developed in 2007, includes issues such as national treatment, which cannot be found in the version from 1967. This suggests that some international norms typically included in IIAs have, over time, found their way into the domain of Indonesia’s national laws, especially as the Indonesian economy has continued on a successful road of development. Secondly, the success of many international negotiations, especially those conducted at multilateral forums such as ASEAN, is dependent on the willingness of states to compromise on a variety of sometimes controversial issues, which implies the necessity to alter national laws in order to conform to the compromises negotiated at the international level. More generally, it is hard to imagine that a country negotiating international treaties will not have to make some adjustments to national laws as a result of such negotiations.

Although the interaction between national and international investment laws is bi-directional, the examination of the Indonesian case study suggests that the influence of international practices and norms on Indonesian national investment policy is more significant than Indonesia’s influence on IIAs. Indonesia has adopted important international practices, such as national treatment, into its national investment policy, but there is little evidence



that the country has contributed significantly to forming and advancing international investment policy, at least not beyond the ASEAN regional context. What Indonesia does have is some power in international advocacy on issues such as further liberalisation and connectivity in the regional context, and the ability to “push back” international proposals that may be contrary to domestic interests or industrial policy. This latter aspect becomes evident, for example, in the transfer of certain far-reaching clauses on manpower issues from the investment law of 1967 into the new law of 2007, and the maintenance of an extensive negative list. This ability to “push back” has implications for the issue of policy space, discussed in further detail below.

### 4.3 Governance mechanisms matter

To advance appropriate governance of investment matters, Indonesia has introduced procedures of inter-ministerial coordination and stakeholder consultations into the process of rule-making on investment. This study suggests that these procedures have been put in place and are being used, but their degree of effectiveness and impact has been questioned, and there is a necessity to review and improve these procedures. Despite existing controversies over the process, the involvement of a variety of stakeholders on issues of investment law is probably an important and useful activity as part of the rule-making process, especially as it might help identify – at an early stage of the rule-making process – potential areas where new measures that are not in line with Indonesia’s international commitments could potentially trigger the emergence of ISDS cases.

Processes of rule-making that involve the participation of affected institutions and stakeholders are not new to the field of policy-making. Quite similar is the practice of “regulatory negotiation” or “negotiated rule-making” applied in administrative procedures in the United States. The concept emerged in the United States during the 1980s and was endorsed by the US Congress in 1990.<sup>220</sup> It formed part of the alternative dispute-resolution movement, suggesting that prior negotiations of regulations that are acceptable to all would prevent disputes and court proceedings at later stages. The procedure

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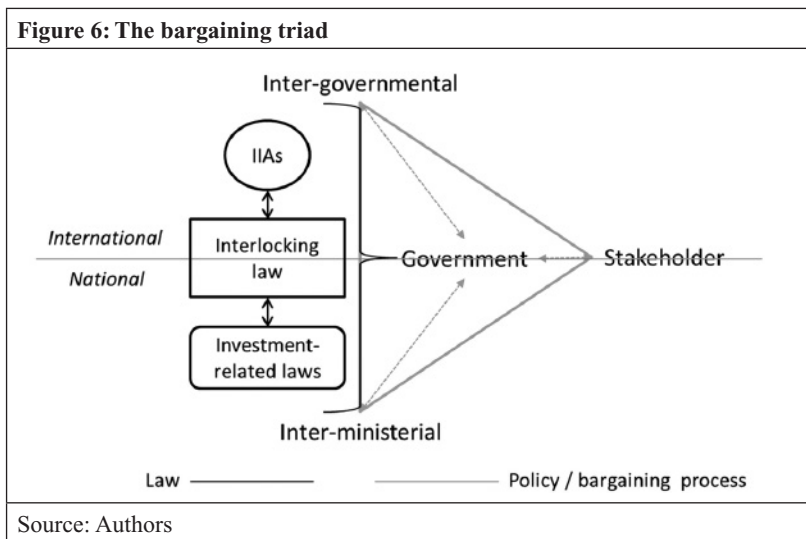
220 See USDA, “What is negotiated rulemaking”; online: <http://www.ams.usda.gov/AMSV1.0/getfile?dDocName=STELPRDC5089434> (accessed 17 Nov. 2013). See also: Negotiated Rulemaking Act of 1990, 104 Stat. 4970 (1990) (codified as amended at 5 U.S.C. §§ 561–570 (2000)) (Funck 2009).

of negotiated rule-making is not without controversy and has both proponents and opponents in governmental and academic circles in the United States (Funck 2009). We do not engage in the debate about the advantages and disadvantages of this approach (see, e.g., Harter 2001; Coglianesi 2001), due to limitations of space, and refer this debate and the discussion on whether this approach is functional in the specific case of Indonesian investment law and policy to future research projects. We do, however, believe that this process is valuable, at least to a certain degree, in managing the interaction between international and national laws and regulations on investment, and in identifying policy space. UNCTAD has also suggested that dispute-prevention policies, such as information-sharing, establishing a lead agency, state-state cooperation in dispute prevention etc., have some potential in reducing the likelihood of ISDS cases (UNCTAD 2010), without allocating explicit attention to the role of negotiated rule-making.

One of the main findings of this study is thus that there is not only international negotiation of investment rules, but also national bargaining of such rules, and both processes interact. The structure of international rules governing investment is largely a result of negotiation among treaty parties and has been widely discussed in the literature on IIAs and investment law. The assumption has often been that other government ministries only need to be informed or made aware of what the agency negotiating investment treaties is doing, attached with a warning about the potential implications that measures enacted by other agencies may have – with international arbitration as the worst-case scenario. But this study has illustrated that, in reality, domestic bargaining among ministries is actually a common feature in the development of domestic investment law – at least in the case of Indonesia – and potentially, domestic bargaining may even occur with stakeholders outside of the government. In other words, international bargaining of investment rules – that is, the negotiation of IIAs – and national bargaining of such rules are happening in parallel, but within very different contexts and in pursuit of different sets of objectives. Not only are there inconsistencies in formal regulations and rules on investment between the international level and the national level, but there are considerable levels of inconsistency between international bargaining (focused on the negotiation of IIAs) and national bargaining (focused on the development of domestic investment-specific laws).

We illustrate this in what we call the “bargaining triad”, which consists of negotiations at the inter-governmental level, inter-ministerial level coordination

and stakeholder consultations, as shown in Figure 6. Bargaining at the inter-governmental level consists of the familiar negotiations of IIAs, in this case involving Indonesia and its treaty partners. Although countries can have an influence on the development of national laws in other countries, their focus is on the conclusion of IIAs through inter-governmental negotiations. Inter-ministerial coordination and bargaining focus on the development of national laws, although ministries can have a considerable impact on international negotiations as well. Finally, consultations with stakeholders can involve national and foreign interests, which may seek to influence international and national laws and policies through the bargaining process.



All members of the triad seek to influence the development of investment-specific national laws, which, in Indonesia’s case, is akin to its interlocking law. Foreign governments have a larger influence on IIAs than on domestic investment laws, whereas national ministries have the strongest influence on their respective investment-related laws, with diminishing impact on the development of the interlocking law or the negotiation of IIAs. The impact of non-governmental stakeholders depends on their precise roles and nationalities. This power structure has to be managed by the national government in the process of managing the interaction between international and national

investment law and policy. A specified agency, such as the BKPM, can be made responsible for negotiating between these different sets of interests.<sup>221</sup>

#### 4.4 Enhancing policy space

International commitments have been shown to limit policy space, but despite these limitations, there is still substantial scope for the state to manoeuvre and make use of its right to regulate. Most interestingly, it appears that IIAs concluded in line with the protection model of investment treaties may limit the amount of policy space more significantly than those concluded in line with the liberalisation model. Despite offering treaty coverage at the pre-establishment phase of an investment, IIAs drafted on the basis of the liberalisation model have a large variety of clarifications and limitations built into the treaty that potentially enhance the regulatory flexibility of the governments concluding the treaty. In line with this, an interesting finding of this study is that the newer, more elaborate IIAs with pre-establishment provisions are not necessarily the ones that result in the initiation of investment disputes. Indonesia's experience shows that very old BITs negotiated on the basis of the protection model are being used to file a claim in international investment arbitration. This may be because – despite larger commitments on issues such as liberalisation and market access being made in newer agreements – these treaties also include more elaborate language with the purpose of hedging against risks and creating more regulatory flexibility.

The actual utilisation of policy space, however, occurs within the realm of domestic investment-specific or -related laws and regulations, and especially the relevant implementing measures. Policy space becomes a reality not through the mere existence of laws and regulations that seek to make use of available policy space, but through the ability to implement and enforce them in a strategic way. In other words, policy space is indeed present when laws are not only drafted but actually implemented and enforced.

An examination of how development considerations are featured in domestic investment law illuminates the discrepancies between the rules and laws in existence and actual implementation and enforcement in light of the

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221 Conceptually, the bargaining triad separates inter-ministerial coordination from the government entities making the ultimate decisions on investment law and policy, although this distinction is not that explicit in practice.

interaction between international and national laws. This study has found that many development considerations are featured much more strongly in domestic law, illuminating the desire of the Indonesian government, but that they are practically absent from Indonesia's IIAs. Table 10 provides examples of such development-oriented aspects that are emphasised much more in national law compared to IIAs. They appear to resemble an attempt by the Indonesian government to legislate investment matters in favour of economic development. But the dilemma may be that international commitments restrict the implementation and enforcement of these measures in practice, especially where the national law is more restrictive than the international commitments made, as in the cases of definitions, personnel and manpower,

<b>IIAs</b>	<b>National law</b>	<b>Nature of discrepancy</b>
Broad definition of investment	Investment “for running business” (Law No. 25/2007, Article 1)	National law development-oriented, but narrower than in IIAs
Provisions on personnel are rare	Prioritisation of employment given to Indonesian citizens, requirement to “improve the competence” of Indonesian workers, requirements of “trainings and transfer of technology” (Law No. 25/2007, Article 10)	National law requires development-oriented approaches to employment, approaches that are not specified in IIAs
Investment promotion is very limited	Wide-ranging “facilities” and investment incentives provided under certain circumstances (Law No. 25/2007, Article 18)	More investment promotion included in national law, along with development considerations
No explicit obligations, but also avoidance of prohibiting the existence of obligations	Various requirements on manpower issues (Law No. 25/2007, Article 10) and CSR (Law No. 25/2007, Articles 15, 16 and 17)	National law is more explicit on investor obligations and requirements in line with development considerations
Source: Authors		

and investor obligations. Policy space is broader with regard to facilitating measures, such as in the area of investment promotion, which Indonesia is also implementing more actively. Therefore, one possible conclusion may be that the utilisation of policy space should focus more on facilitating measures than on restricting measures, in particular as the former are likely to be much less contentious, and hence less risky for the government.

The risk of getting involved in ISDS cases depends in part on the degree to which laws in areas where discrepancies exist are actually enforced in practice. In particular, with respect to some of the development-oriented provisions in Law No. 25/2007, enforcement and implementation of regulations may actually be lacking, indicating a lack of policy space. In other words, the consequences of a law are not only dependent on the nature of the formal laws and legal texts – what is also important is the extent to which these laws and regulations are actually implemented in practice. It is possible to have many laws and a solid legal framework, but unpredictable levels of enforcement and implementation. This study suggested earlier that investors are likely to focus more on national laws and their enforcement rather than on international commitments. Therefore, a transparent and consistent approach to national legislation, together with appropriate implementation and enforcement of such rules, may be as important as the issue of consistency with international commitments. If the policy space is not there, both the laws and the implementing regulations should reflect this.

Similarly, disputes are unlikely to emerge directly on the basis of the interlocking law. This is because the law in itself has no significant effect on investors and their investments, as long as it is not followed up with relevant implementing regulations. It is likely that those implementing regulations – found in column 4 from left in Table 6 and in section 3.5 of this study – are the measures that could lead to an investment dispute.

Given this danger that implementing regulations might trigger investor-state disputes, and in view of the already existing disputes, governments may be deterred from legislating in the first place or from implementing already existing laws, resulting in a “regulatory chill” effect that could go against the achievement of public policy objectives. It might be possible to avoid such an effect by using available policy space and the right to regulate with caution and foresight. In developing the appropriate implementing regulations, the state can draw on inter-ministerial coordination and stakeholder consultations to better determine how far it can go with any new measures. This will allow

the state to adapt new measures as optimally as possible to its development needs, whilst taking potential consequences into account, such as the emergence of investor-state disputes. Through a process of “negotiated rule-making”, governments can achieve greater certainty about the kinds of measures that still lie within the available policy space. Caucusing viewpoints among government ministries and domestic as well as foreign stakeholders – including the investors themselves or their associations – could help in avoiding inappropriate measures from being developed that might require readjustments at a later stage, or even lead to investor-state disputes.

Communication is key in this context, which includes communicating and explaining clearly the purpose and content of anticipated new measures prior to their enactment, and openly involving government agencies and other interested stakeholders alike in the development of the measures. The communicated objective of a measure should be in line with the public interest, such as addressing a development objective of the state. Appropriate reasoning, including plausible economic logic, should be behind a measure, and stakeholders should be allowed to contest measures where this is in doubt. Governments should make sure that measures are implemented after they have been fully developed, and the consequences and feasibility sufficiently examined, in order to avoid any backtracking or amendments. In other words, it is better to develop measures with due care and allowing substantial amounts of time than to backtrack on a hastily enacted measure. Finally, it is important to emphasise that governments should have the final say about a measure, and not become pressured by the stakeholders (or agencies) consulted. In the end, the government must remain the ultimate decision-maker.

## **5 Beyond the Indonesian case: general conclusions and recommendations**

This study has provided detailed insights on how key IIA provisions and domestic laws and regulations interact. In order to undertake such an analysis, the study has focused on a case study of the Indonesian legal framework for investment, applying an innovative pattern-matching technique. However, for the purpose of drawing more general conclusions about investment policy-making, it is important to move from the particular context of the Indonesian case towards reconsidering the general lessons to be learnt from this study. It is important to consider whether the case of Indonesia,

examined in this study, constitutes an example of “best practice” or “good practice” that could be copied by other countries. We therefore conclude this study by highlighting some more general insights, policy recommendations and areas for further research. We emphasise four particular aspects: the interlocking law, the bargaining triad, identifying and managing policy space, and this study’s innovative analytical approach.

In Indonesia’s case, key IIA provisions were replicated in domestic laws and regulations in a very structured way, applying core elements almost one-to-one in the relevant national law – Law No. 25/2007 concerning Investment – which is why we have, within this study, referred to this law as the “interlocking law”. It is beyond the scope of this study to determine whether other countries’ domestic legal frameworks address this issue with a similar degree of structure and transparency, and we have not investigated whether other countries’ domestic legal frameworks on investment utilise an interlocking law.<sup>222</sup> We may expect different set-ups in other countries, as the APEC-UNCTAD study on IIA core elements in domestic legal frameworks (APEC / UNCTAD 2011) suggests.

What this study does suggest is that the use of an interlocking law is an interesting and promising way of linking international commitments with national laws in a transparent manner, thereby dealing with the problem of complexity and possibly reducing the risk of ISDS cases, although more evidence on the latter benefit is still required. Other countries could consider replicating this approach in order to better organise their investment policies. However, further studies of other countries will be necessary to identify alternative approaches and confirm the feasibility of an interlocking law, especially for other developing countries that do not possess the governmental capacities of Indonesia. Similarly, it needs to be seen whether the Indonesian approach in IIAs to frequently and explicitly refer to domestic laws and regulations in general – and the interlocking law in particular – could be interpreted as a “good practice” to hedge against possible risks resulting from international commitments. Here again, looking at the practices of other countries on this issue would be necessary to determine the extent to which the Indonesian approach is unique, and to comparatively evaluate the appropriateness of the Indonesian approach.

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222 The recent introduction of a Foreign Investment Act and the establishment of an Investment Ministerial Committee in South Africa indicate that other countries are implementing governance structures similar to Indonesia’s.



In general, rules should be defined in a participatory and transparent way. This study finds, however, that inconsistencies in legal rules are normally paralleled by inconsistencies in inter-governmental, inter-ministerial and stakeholder approaches to investment policy, illuminating the need for compromise. Based on this study's findings, we think it useful for a government to consider the views of all members of this triad when developing investment laws, provided that it maintains its final decision-making authority. A governance mechanism that takes account of various perspectives will likely be more effective in defining the appropriate content and wording of laws (including the interlocking law), in identifying available policy space and in preventing investment disputes. Partially as a result of this, the interaction between international and national rules and interests will be bi-directional. Involving the triad will also make the policy-making process smoother and reduce the likelihood that new laws and regulations have to be corrected shortly after enactment.

Because of the vagueness of the policy space concept, we did not have the ambition in this study to explicitly measure the extent to which international commitments on investment limited policy space. Rather, the important finding in this study on the issue of policy space is that governments have tools at their disposal to identify policy space, thereby avoiding the emergence of ISDS cases resulting from measures that have taken a step too far. These tools include involvement of the triad in the development of investment policy through a governance approach that provides the government with further clarity on the extent to which specific laws and measures are feasible or might pose risks of international arbitration. Involving the triad could also be used to identify areas where it would or would not be advisable for a government to make use of available policy space, with due consideration to issues of domestic economic development.

We also find that the newer IIAs that follow the liberalisation approach potentially offer more opportunities to maintain policy space than do many of the older IIAs that follow the protection approach. Host-state governments ought to watch their older BITs, and if too many cases emerge from them, devise strategies to ameliorate the situation – in particular when cases challenge legitimate public policy objectives. Such strategies may include renegotiation of treaties.

Given the interesting insights gained from the Indonesian case study, the findings of this study could be particularly useful for developing countries

that are just beginning to develop or reform their investment policy regimes, and are possibly starting to draft a national investment law while eyeing the possibility of negotiating IIAs. Another ASEAN economy – Myanmar – is currently a particularly notable example. With Myanmar's current ambitions to open up its economy, it has been in the process of developing an investment legal framework and passed a new foreign investment law in November 2012 (Turnell 2013). This study has provided some insight on the considerations that matter for countries such as Myanmar that are in the process of developing a legal framework on investment.

This study, to the best knowledge of the authors, is the first to have directly juxtaposed national and international investment laws in greater depth. Our findings have important implications for research on national and international investment laws as well as for policy advice offered by international organisations to developing countries in the area of investment policy-making. It is worth highlighting that, by directly juxtaposing international commitments on investment with national laws and regulations, this study has ventured into a new field. The myriad of existing publications on IIAs as well as national laws and regulations on investment – including the many available investment policy reviews by UNCTAD and the OECD – have made important contributions to our understanding of both domestic laws and regulations as well as international agreements. However, the national and international dimensions have usually been treated separately and without direct juxtaposition.

Over the last few years, a new consensus has been emerging that calls for a reconsideration of IIAs and their contribution to sustainable development in host states. However, without a sound grounding of IIA analysis in national investment law – and more broadly, in national development strategies – it will not be possible to redesign IIAs in such a way that they contribute to sustainable development. From an analytical perspective, it is important for researchers as well as policy advisers to overcome the separation between national and international investment laws while moving towards a two-level logic by analysing international and national investment law in a more integrated way. Initial steps towards juxtaposing these two bodies of law were taken in APEC and UNCTAD (2011), although the findings remained quite general. UNCTAD's recent publication "Investment Policy Framework for Sustainable Development" (UNCTAD 2012a) also discusses both national and international investment policies in some detail. However, these previous attempts remain incomplete.

In fact, by making this juxtaposition, this study has developed a useful methodological blueprint – an innovative pattern-matching technique – for how to comparatively examine international commitments made in IIAs with national laws and regulations on investment. This method suggests a stepwise approach: first, the analysis should start with a mapping of all IIAs that a country has signed; second, these IIAs will be compared with national investment-specific and then investment-related laws through juxtaposition; third, individual and controversial measures should be considered in a bit more detail, and their potential implications discussed; and finally, the nature of inter-ministerial coordination and stakeholder consultations related to investment issues should be examined through empirical research, taking account of previous and current inter-governmental negotiations of IIAs. The value of this methodology is that it is more holistic in examining investment law and policy, and it can provide insights on issues such as consistency between domestic laws and regulations and international commitments; potential risks of inconsistencies; and implications for national policy space and economic development. We hope that future studies will use this methodology to undertake similar analyses of other countries' legal frameworks for investment in order to overcome the separation between national and international perspectives that is endemic in the research and policy advice on the subject. The objective would be to build up a body of literature that examines this neglected area of inquiry in the field of investment law.

Future research should therefore examine how other countries replicate key IIA provisions in domestic laws and regulations. Eventually, comparative case studies of several countries should analyse the entire investment legal frameworks of these countries, including international commitments and national laws, and compare these frameworks with each other. This will allow for the identification of different practices in this area and lead to the possibility of discerning “best practice” approaches. At the same time, future research could focus on smaller parts of the investment legal frameworks of countries, such as individual IIA provisions and how these are replicated in national laws and regulations. For example, a study could just look at how “expropriation” or “transfer of funds” is addressed in various domestic investment laws. This will allow for a more detailed examination of relevant issues than was possible in this study, and allow for going deeper into a particular set of national laws and regulations. In other words, much work still needs to be done in this very new area of inquiry.



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