CHAPTER I

INTRODUCTION

1.1 Background

Globalization is one of the most frequently used words in discussions of development, trade, and international political economy.[1] As the form of the word implies, globalization is a process by which the economies of the world become more integrated, leading to a global economy and, increasingly, global economic policy making, for example, through international agencies such as the World Trade Organization (WTO).[2] Historically, the explosion of world trade after the World War II has increased the export of goods. The growing interdependence among nations was influenced by the scarcity of technology, capital, and natural resources. Those factors forced industrialized countries that had more capital and more developed technology to interact with developing countries in exchange of natural resources.

The condition of countries in this 21st century generally has placed developing countries in the equal stage of industrial development. It also can be said that those countries have market size that slightly different, also have a strong interest to coordinate and rationalize the growth patterns of their combined industry in order to gain benefits from either outward or inward looking policies in the framework of economic

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[1] This discussion draws on World Bank, Poverty in an Age of Globalization (Washington, D.C.: World
Bank, 2000); Sarah Anderson and John Cavanaugh, with Thea Lee, Field Guide to the Global Economy (New York: New Press, 2000).

[2] Michael P Todaro and Stephen C Smith, *Economic Development - 11Th Edition* (1st edn, Pearson Addison Wesley 2012). Page 564-565.

integration.[3] The increasing need of nations has resulted in the growing interactions as well as interdependence among countries around the world that is marked by the rise of bilateral and multilateral economic cooperation. Many countries enter into those agreements in order to benefit from market liberalization.

The further step in globalization is reducing the trade barriers. By reducing the trade barriers, will also increase Foreign Direct Investment flows (FDI) among countries. Countries can have greater access in international market which allowing them to expand their overseas operations and capture a bigger share of the global market. Eventually, it will enable countries to accelerate its economic growth. In addition, globalization also allows the freer movement of people, goods, and services.

The impact of globalization as resulted from trade liberalization that allows the free movement of capital and people can become a threat particularly for developing countries as they do not have such a big capital and skilled people to compete in the global market compared to developed countries. Globalization also can raise other concerns such as wages inequality, declining in manufactory jobs due to lower wages and cheaper technology in other countries, and the increase of power of the dominant countries that will cause marginal countries left behind. However, globalization also can facilitate economic growth by enabling transfer of knowledge and technology from developed countries to developing countries. It also expands business opportunities and delivers competition resulted from the flow of foreign direct investment. Thus globalization carries benefits and opportunities as well as costs and risks.

In order to benefit from globalization, Indonesia has participated in a number of regional cooperation such as AFTA (ASEAN Free Trade Area) and APEC (Asia-Pacific

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[3] P. Todaro, Michael & C. Smith, Stephen., Pembangunan Ekonomi Edisi Kesembilan, terj. Andri Yelvi, Jakarta: Erlangga, 2006, hal 183.

Economic Cooperation). It is an important element in relation with Indonesian's globalization policy schemes. Regional cooperation helps its participants to take part in global economic integration more effectively as a group of regional economies. In Southeast Asia, AFTA and APEC are widely seen as representing indeed as manifesting the globalization phenomenon because of the importance of trade and investment liberalization in these organizations' agenda.

As a developing country, Indonesia certainly intends to attract foreign direct investments to boost its economic growth and development. Since the mid-1980s, Indonesia has substantially liberalized its trade and investment regimes. These policies have been introduced in response to what the government perceives to be a trend toward globalization and the international integration of markets. Furthermore, it is believed that the country will gain significant net benefits from its participation in this process. The policy of globalization has necessitated the introduction of a series of structural adjustments in Indonesia's economy through liberalization, marketization and deregulation, as well as privatization.

Nowadays, Indonesia has continued along its path of economic liberalization by way of 12 economic deregulation packages to open up various sectors to foreign investment. It has also taken steps to improve the efficiency and streamline the processes allowing for FDI to enter into Indonesia. One such example is the one-stop service at the Investment Coordinating Board of Indonesia (BKPM) for the incorporation, relevant licensing and approval of companies with foreign ownership.

One of the key players who involved in the global market is Multinational Corporations (MNC) that consists of foreign investors and individual businessmen. MNCs play a key role as engines of economic growth. They act as the vanguard of the liberal economic order. Furthermore, they have taken the integration of national

economies beyond trade and money to include the internationalization of production. They perform economic activities that include direct importing and exporting, making significant investments in a foreign country, buying and selling licenses in foreign markets, engaging in contract manufacturing, and opening manufacturing facilities in foreign countries.[4]

Joining into International Investment Agreements (IIAs), which include Bilateral Investment Treaty (BIT) and other regional, multilateral as well as economic integration, is a way to attract FDI that is required to help Indonesian economic development. It emphasizes the commitment of Indonesia to protect the foreign investment as well as to assure the legal certainty. However, a clause related with foreign investment, particularly regarding Investor-State Dispute Settlement (ISDS) has become a major concern for the government of Indonesia. This ISDS clause includes a unilateral offer of consent to arbitration by the host state. It means that the investor who is covered under the relevant IIA can 'perfect' the consent of both parties and able to submit a dispute to arbitration by filing a request for arbitration.

Therefore, it was announced in March 2014 that Indonesia intended to "terminate" the Netherlands-Indonesia Bilateral Investment Treaty (BIT).[5] While Indonesia used the expression "terminate", its approach was in fact not to renew the Netherlands-Indonesia BIT after its expiry on 1 July 2015. In the same announcement, Indonesia stated that it similarly intended to terminate all of its 67 BITs.

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[4] http://www.wwnorton.com/college/polisci/essentials-of-international-relations5/ch/09/summary.aspx

[5] Announcement by the Netherlands' Embassy in Jakarta <http://indonesia.nlembassy.org/organization/departments/economic-affairs/termination-bilateral-investment-treaty.html>

Indonesia is currently undergoing a thorough review of its 64 BITs as well as Investment Chapters under various free trade agreements.[6] The review envisages a critical evaluation of the impact of existing IIAs on the Indonesian national economy and formulation of a new approach towards IIAs, which will be fine-turned in favor of its interest in pursuing national development goals. The rationales for the review conducted by Indonesia are essentially similar to the rationales undertaken by other countries, including:[7]

1) to strike a balance between investor protection and national sovereignty;
2) most provisions of the existing IIA are outdated as they grant extensively broad protections and rights for foreign investors;
3) one of Indonesia's greatest concerns regarding IIAs is the provision on the Investor-State Dispute Settlement (ISDS), which has increased Indonesia's exposure to investor claims in international arbitration; and
4) the provisions in IIAs may potentially override national legislation.

The review process undertaken by Indonesia had addressed almost all common provisions included in IIAs. Yet, the most outstanding issue in the review process is the ISDS.

ISDS is a key feature of IIAs, which include BITs and other regional multilateral agreements. The underlying factor for the inclusion of ISDS clauses is to provide protection for the foreign investors in the event of the host-State breaches its obligations under the relevant IIA and international law. It provides a compensation for the foreign investors if the allegation is justified.

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[6] https://www.southcentre.int/wp-content/uploads/2015/07/IPB1_Indonesia-Perspective-on-Review-of-Intl-Inv-Agreements_EN.pdf
[7] https://www.southcentre.int/wp-content/uploads/2015/07/IPB1_Indonesia-Perspective-on-Review-of-Intl-Inv-Agreements_EN.pdf

The first establishment of ISDS was in 1959, in a bilateral trade agreement between Germany and Pakistan. The intention was to encourage foreign investment by protecting investors from discrimination or expropriation. However, the implementation of this laudable idea has been disastrous.[8] Multinational corporations have exploited woolly definitions of expropriation to claim compensation for changes in government policy that happen to have harmed their business.

The largest claim mounted by an investor against Indonesia is in the case of *Churchill Mining PLC and Planet Mining Pty Ltd v Republic of Indonesia ('Churchill Mining')*.[9] It has sued the government of Indonesia for over US$1 billion in damages after what the former alleged to be the expropriation of its rights over huge coal reserves in East Kalimantan. The main reason behind the lawsuit by Churchill against the government was the questionable permits issued by the regional administration and the forged documents used to support the licensing process.

Basically, the ISDS mechanism was designed to depoliticize investment disputes and create a forum that would offer investors a fair hearing before an independent, neutral and competent tribunal. It was seen as a mechanism for rendering final and enforceable decisions through a quick, cost effective, and flexible process over which disputing parties would have control.[10] This mechanism allows foreign investors to bypass local courts and seek compensation in international tribunals such as the ICSID for what they claim to be damages caused by expropriation or policy or contractual changes by host governments.

[8] http://www.economist.com/news/finance-and-economics/21623756-governments-are-souring-treaties-protect-foreign-investors-arbitration
[9] ICSID Case Nos ARB/12/14 and ARB/12/40.

[10] Reform of Investor-State Dispute Settlement: In Search of a Roadmap, UNCTAD IIA Issues Note No 2, June 2013.

Indonesia has the highest number of international arbitration cases among the member States of the Association of South East Asian Nations (ASEAN),[11] having been involved in approximately 10 ISDS cases (at least six of them being ICSID cases). Although ISDS mechanism is necessary to encourage foreign investment and to protect foreign investors by arbitrary and rogue unilateral decisions by host government, however, Indonesia's experience in grappling with its many disputes with foreign investors over the past four decades has shown how a number of foreign investors have exploited the ISDS mechanism to circumvent national regulations and bully the government.

With the proliferation of ISDS claims in the past decade, several main criticisms have been leveled at existing ISDS mechanisms, including (as summarized by UNCTAD):[12]

1) that it grants foreign investors greater rights than those of domestic investors and creates unequal competitive conditions;
2) that it exposes States to legal and financial risks without bringing any additional benefits;
3) that it lacks sufficient legitimacy (ISDS is modeled on private commercial arbitration, lacks of transparency and raises concern about arbitrator's independence and impartiality);
4) that it fails to ensure consistency between decisions adopted by different tribunals on identical or similar issues;

[11] Abdulkadir Jailani, 'Indonesia's Perspective on Review of International Investment Agreements', in Kavaljit Singh and Burghard Ilge (Eds), Rethinking Bilateral Investment Treaties: Critical Issues and Policy Choices (Bothends, 2016).

[12] World Investment Report 2015 Chapter IV Reforming the International Investment Regime: An Action Menu, p 147, Table IV.5.

5) that it does not allow for the protection of erroneous decisions for appeals;
6) that it creates for 'nationality planning' by investors from third countries in order to gain access to ISDS;
7) that it is very expensive for users; and
8) that it holds additional value in the presence of well-established and well-functioning domestic legal systems.

The major concern within the ISDS scheme is that only investors or companies who is able to bring lawsuits. A government is not a party who can commence a dispute against an investor or a company. Hence, the government can only defend itself. Furthermore, it does not have a sufficient control over a claim brought by foreign investor whether it will be resolved in arbitration proceedings.

ISDS is the key impetus for Indonesia's reform in the IIA sphere. This point was succinctly put by Abdulkadir Jailani, a Director at the Indonesian Ministry of Foreign Affairs, who is heading the review of Indonesia's IIA/BIT framework and the development of the draft model BIT: "[Indonesia's] perspective on BITs has changed. It seems very much in favor of the investor. Our number one problem is ISDS."[13]

Additionally, Indonesia is signatory to a number of regional and multilateral investment agreements that have ISDS clauses similar to those in BITs. In addition to these clauses, the investment chapters of these agreements contain substantive obligations, including, among others, NT and MFN, which would be broader than the approach that Indonesia is adopting in its draft model BIT. These include:

[13] Inter Press Service News Agency, 28 December 2015, available at http://www.ipsnews.net/2015/12/american-mining-giant-escapedindonesian-law-with-isds.

1) the ASEAN Comprehensive Investment Agreement;
2) various ASEAN FTAs with Australia, New Zealand, China, Japan, Korea and India; and
3) the Organization of Islamic Cooperation (OIC) Agreement.

Besides becoming a party to a number of BITs and other multilateral agreements as mentioned above, Indonesia has ratified the International Centre for Settlement of Investment Disputes (ICSID) Convention in 1968. It also has ratified a specific investment agreement, the ASEAN Comprehensive Investment Agreement (ACIA). As the consequences, there is a possibility that for investment disputes between the government and foreign investors will continue to be settled in international forum, especially the ICSID forum as one of the most competent forums to settle investment disputes. Therefore, qualifying foreign investors can still reap the benefits of these agreements.

The signing of the ASEAN Charter in December 2008 marked a new chapter of ASEAN cooperation from what previously called as "fraternity" into an organization that is based on a shared commitment that is legally binding. ASEAN Charter provides a strong basis for intra-regional cooperation and more effective international role. With the clarity of vision, goals, better organizational structure, decision-making mechanisms and conflict resolution mechanisms, and enhancing role and mandate of the ASEAN secretariat, it is expected to further ensure the implementation of ASEAN agreements that have been reached.

In the end of December 2015 these ten economies Association of Nations of Southeast Asian Nations (ASEAN) actualized the ASEAN Economic Community (AEC), to create a highly competitive single market and production base that can foster a fair economic development to all member countries as well as facilitate integration with

global society. In order to achieve this target, ASEAN adopted the AEC Blueprint in November 2007, which outlines the steps that will be implemented based on the implementation schedule. The AEC Blueprint is built on four interrelated and mutually reinforcing pillars:[14] (a) a single market and production base; (b) a highly competitive economic region; (c) a region of equitable economic development; and (d) a region fully integrated into the global economy.

The four pillars of AEC have an agreed legal frameworks in the form of the ASEAN Trade in Goods Agreement (ATIGA), which regulates the free flow of goods, ASEAN Frame Work on Services (AFAS), which regulates the free flow of services, the ASEAN Comprehensive Agreement on Investment (ACIA) which regulates the free flow of investment, and the Chiang Mai Initiative Multilateralization (CMIM), to regulate more freely capital flows.

Free flow of investment is very important for ASEAN member countries. According to the book about general information of ASEAN economic community that published by Ministry of Commerce in 2011, the flow of foreign direct investment into ASEAN was relatively high. Furthermore, even when there was a global crisis in 2008, foreign direct investment to ASEAN reached US$59.7 billion. In 2010, total direct investment into ASEAN was recorded to reach US$75.8 billion, or more than doubled compared with 2009. Most of the direct investment comes from the service sector. In 2010, the contribution of the service sector reached 65.7 percent, while the manufacturing sector amounted to 28.1 percent.[15] By contrast, growth in intra-ASEAN investment flows

[14] (2016) <http://www.asean.org/storage/images/2015/November/aec-page/AEC-2015-Progress-and-Key-Achievements.pdf> accessed 24 December 2016.

[15] Kompas Media, 'Liberalisasi Investasi Tahun 2012' (*Bisniskeuangan.kompas.com*, 2016) <http://bisniskeuangan.kompas.com/read/2011/08/15/02224425/Liberalisasi.Investasi.Tahun.2012 > accessed 24 December 2016.

has not been optimal. Recognizing the importance of the flow of investment funds as a component of development, each ASEAN member countries have attempted various reforms on its investment regime, which subsequently being coordinated in a regional cooperation body. Therefore, the leaders of ASEAN member countries strive to create conducive investment climate to increase intra-ASEAN investment and improve competitiveness to attract foreign direct investment to ASEAN through legal statue of ACIA.

Investment Agreements are generally beneficial for the development of the ASEAN Economic Community because it becomes a tool to encourage Foreign Direct Investment (FDI) by providing commitments toward trade liberalization, protection for both investor and investment, also dispute settlement system. In other words, transparency and consistency of legal system are required to attract FDI, and it is reflected in the Investment Agreements. In relation to this, by attracting more FDI, it will bring more benefits for AEC in the long run, particularly in the development of its economy inter alia will increase production networks by liberalizing trade flows, transfer of knowledge and technology, and also will support the economic growth with capital injection to create more employments. The growing of economy will eventually lead to the decreasing of poverty.

According to Abdul Kadir Jilani (Director of Economic and Social Agreement Culture, DG HPI-Ministry of Foreign Affairs), discussion on foreign investment is an interesting topic, which at once sensitive, because with globalization, in particular trade flows of investment flows from one country to another is increasing. The origin of international investment law is the customary international law of state responsibility

regarding the minimum standard of treatment that the state must provide equal treatment to foreigners.[16]

In the principles of foreign investment protection laws, it is also often found the provisions set by the government on how to protect foreign investors or how should the government protect foreign investors, which can raise the issue of discriminatory against domestic investors. Basically, the protection of foreign investment due to the respect for human rights that is linked to: (1) maintain good relations between countries; (2) the economic interests to protect foreign capital; and (3) the legal protection for foreign investors.

In this research, the writer limits the issues that will be discussed in order to focus on the investment provisions and investor state dispute settlement mechanism. In association with the Law of the Republic of Indonesia Number 25 Year of 2007 concerning on Capital Investment, ISDS provision as governed in the ACIA has covered investment dispute settlement in more specific compared to this law.

Therefore, the writer will write a thesis with title "COMPARISON OF INVESTMENT DISPUTE SETTLEMENT BETWEEN STATE AND NATIONALS OF OTHER STATE IN THE ASEAN COMPREHENSIVE INVESTMENT AGREEMENT AND INDONESIAN LAW NO.25/2007 REGARDING CAPITAL INVESTMENT" to explore the challenges for Indonesia in dealing with ISDS and to demonstrate the comparison of investment dispute settlement mechanism between these provisions.

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[16] Lecture delivered in a Course with Practitioners, organized by the Law Unit Career Development Center at the University of Gajah Mada May 19, 2015

1.2 Research Questions

This research will be based on the following problem statements:

1. How is the provision of investment dispute settlement between the State and Nationals of other State regulated under the Indonesian Capital Investment Law?
2. How is the establishment of ACIA influence Indonesian Capital Investment Law to comply, particularly with the ISDS provision?

1.3 Objective of Research

The objectives in conducting this research are:

1. To analyze the implementation of Law No. 25/2007 concerning on Capital Investment in resolving the dispute between the Government of Indonesia and Nationals of other State.
2. To analyze the establishment of ACIA as a framework of FDI legal substance and investment dispute settlement mechanism among ASEAN member countries and its influence towards the implementation of Law No. 25/2007.

1.4 Benefit of Research

The outcome of this research is expected to provide benefits not only for myself, but also for external parties. This benefit is distinguished into two terms in order to understand the usefulness of this research from academic perspective as well as practical perspective.

1.4.1 Academic Aspect

In term of academic aspect, this research is expected to enrich literatures and provide information and inputs to the writer of this thesis, the public, students, and scholars of the legal science. This research will focus on enriching the authors and readers concerning the challenge to Indonesia in dealing with investor-state dispute settlement.

1.4.2 Practical Aspect

In term of practical aspect, this research is expected to help the legal practitioners and non-legal practitioners related to International Investment Law and International Political Economy.

1.5 Structure of Writing

In order to simplify the writing and discussions, the writer divides this paper into five chapters, where each chapter is correlated one with another. In brief, the chapter will be discussed as explained below.

CHAPTER I INTRODUCTION

The first chapter is an introduction that includes the background of the topic selection, formulation of issues, objectives of research, benefits of research and systematic of writing.

CHAPTER II – THEORETICAL AND CONCEPTUAL FRAMEWORKS

The second chapter is a discussion on the concept and understanding of issues in relation with theoretical frameworks. It also includes the explanation of dispute

settlement mechanism and the procedures involved in the process. Furthermore, the ASEAN Cooperation in Investment Sector and the establishment of ACIA is also described in this chapter.

CHAPTER III – METHOD OF RESEARCH

The third chapter discusses the methods of legal research used in writing this thesis, which consist of the type of research, procedures to collect research materials, the character of analysis, obstacles and overcoming those obstacles.

CHAPTER IV – ANALYSIS

The fourth chapter elaborates the result of the research. This comprises the analyses of Investment Dispute Settlement Mechanism between State and Nationals of other State in accordance with Indonesian Capital Investment Law and as governed by the ASEAN Comprehensive Investment Agreement (ACIA).

CHAPTER V – CONCLUSION AND RECOMMENDATION

The fifth chapter is the closing chapter that contains the conclusions and recommendations. The conclusion is directed to the designated problem. The suggestion, on the other hand, is recommendation from the writer in order to solve the existing problem.