Checkmate ! : The US-Indonesia Bilateral Free Trade Agreement

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CHAPTER 3: DEVELOPMENT ISSUES IN INVESTMENT RULES UNDER A BILATERAL FREE TRADE AGREEMENT WITH THE US

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Introduction

In 1998, at the height of the economic crisis and socio-political reforms, the Federal Government of Germany, together with the Japanese and the United States (US) governments, sent a letter to the Indonesian Minister of Finance calling on the Indonesian government to 'protect the fundamental rights of investors'. The letter was sent in reference to the Paiton I and Paiton II coal-fired power generation projects, which were secured during the end of Soeharto's 30 years of corrupt, authoritarian rule in Indonesia (Drillisch and Sekler 2004). A description of the case and the controversy over the investment guarantee schemes put in place by industrialised government to protect their private sector investors is provided in Box 1. The Paiton case is an important illustration in this paper of the increasing power of private investors over governments and nations, not just in developing countries, but also in industrialised ones.

Investment, particularly foreign investment, is hailed as an effective instrument for capital formation in developing countries, and as an engine for economic growth. In that context, developing countries often manage investment in order to create capital to help finance development

and improve domestic capacity. As such, governments create rules that balance the rights and obligations of investors against the benefits that will accrue to host countries. But, at the international level, it is increasingly investors' rights that are being advocated for, at the expense of benefits for host countries. Many attempts have been made to disproportionately strengthen investors' rights, such as through the aborted proposal for a Multilateral Agreement on Investment (MAI),[1] and the proposal to negotiate investment rules at the World Trade Organisation (WTO),[2] which was withdrawn from the agenda in 2004. Both contained proposals to deregulate and liberalise investment through strengthening investors' rights and allowing them greater freedom, and minimising the regulatory functions of government.

Investment liberalisation rules now commonly feature in bilateral and regional Free Trade Agreements (BFTA / RFTA). The North America Free Trade Agreement (NAFTA), for instance, contains an investment chapter that provides rules for investment liberalisation. These rules have been used by the US when negotiating free trade agreements (FTAs)

1 MAI was initially negotiated in secret by the Organisation for Economic Co-operation and Development (OECD) countries in 1997. The proposed Agreement consisted of investment liberalisation, the protection of investors' rights, and the elimination of conditionalities for investors, such as performance rights and the right to sue states. When the documents were leaked to the European public, various non-governmental organisations (NGOs) and civil society groups criticised the process and staged massive protests, forcing some European governments to stop the negotiations (Jhamtani 2005).

2 Investment liberalisation was first put on the agenda of the WTO at the first ministerial meeting, or in 1996, by developed countries. It was proposed that the issue of investment liberalisation based on WTO principles should be studied. In 2001, the Doha agenda included a proposal for negotiations on investment. However, the WTO negotiations collapsed in 2003, and the investment agenda was withdrawn in 2004, mainly due to opposition from developing countries. This issue has now been shifted into bilateral negotiations. Detailed information on this can be found in the official website of the Third World Network (TWN) at: www.twnside.org.sg

with other regions and countries. Similarly, the US-Singapore FTA contains an investment chapter similar to the NAFTA chapter, whilst the proposed US-Thailand and US-Malaysia FTAs will probably have the same. Meanwhile, Indonesia is about to conclude negotiations with Japan under the Indonesia Japan Economic Cooperation Agreement (IJEPA), which may contain elements similar to those in US-led FTAs, and there have been talks about an initial joint study on the possibility of an FTA with the US. Negotiating documents for these FTAs are not made public and, therefore, the content of all the chapters, including the investment chapter, are made known only after the negotiations are concluded.

This paper analyses the possible development impacts of investment liberalisation rules under any future agreement between the US and Indonesia. Such an agreement could be a Bilateral Investment Treaty (BIT) or a BFTA. Since there is no actual US-Indonesia Free Trade Agreement (USIFTA) as yet, this paper provides a projection of the potential impacts, based not only on the content of investment chapters from existing treaty documents, such as the US-Singapore FTA and the draft of the US-Thailand FTA, but also on other studies, and interviews with Indonesian experts. This paper consists of three parts. The first part examines the current investment climate in Indonesia and the US, as well as investment relations between the two countries. The second part outlines the key elements of investment chapters in other US FTAs, whilst the third part analyses the projected impacts on development should Indonesia agree to a US-proposed investment chapter in the future. The paper concludes with an outline of the elements needed for a fair investment treaty.

The investment scene in Indonesia and the US

Investment in Indonesia

Before the financial crisis in 1997, Indonesia attracted substantial foreign direct investment (FDI), amounting to US$ 6,194 million in 1996, ranking it the second largest recipient of FDI after the People's Republic of China (PRC) in the Asian region. FDI began to decline during the 1997-98 financial crisis. Gross domestic capital formation plummeted

sharply, by 33.0 percent in 1998 and by 18.2 percent in 1999. In fact, since 1998, Indonesia has seen net FDI outflows of US$ 356 million, peaking at US$ 4,550 million in 2000 (Hutagalung 2003). Although the Indonesian economy has experienced progressive recovery with real GDP growing 4.9 percent in 2000 (compared to minus 13.1 percent in 1998), 3.4 percent in 2001, and 3.7 percent in 2002, FDI inflows into the country still remained negative, or minus US$ 3,278 million in 2001, and minus US$ 1,513 million in 2002. In 2002, FDI approvals plummeted by 35 percent, whilst domestic investment approvals dropped by 57 percent. Up to September 2003, approved FDI was about $ 6.0 Lawion, which was less than one third of the pre-crisis level of about $ 34 Lawion in 1997 (Hutagalung 2003). Following a period of uncertainty in 2004 due to general elections, FDI gained momentum and in 2005 inflows increased to US$ 6,922 million from US$ 3,860 million in 2004 (World Bank 2006).

Although economic growth resumed during the post-crisis period, investment recovery has not been significant. Despite strong growth in 2004 (14.6 percent) and 2005 (9.9 percent), investment, as a share of GDP, remains at 22 percent, about 8 percent below its pre-crisis peak in 1996. The Indonesian Finance Minister, Sri Mulyani, has suggested that if Indonesia was to attain economic growth of 6.3 percent in 2007, it was imperative that the country attract Rp. 989 trillion of new investment, or a 12.3 percent increase from the investment value of the previous year (Kompas 2006). All categories of investment have declined, with private investment experiencing the worst decline before beginning to recover in the 2004-05 period. In 1996, investment reached its all-time high of 29.6 percent of GDP, whilst private investment was 22.6 percent and public investment was 7.2 percent of GDP. In 2000, public investment fell to 3.9 percent, or about half of the pre-crisis period, and private investment was only 16 percent. Between 2000 and 2003, public investment recovered to near pre-crisis levels, but private investment fell further to 12.8 percent (World Bank, 2006). Table 1 presents FDI by country of origin for 2000-2004.

Table 3.1.
Foreign direct investment in Indonesia by country of origin, 2000-2004
(US$ million)

Origin	2000	2001	2002	2003	2004
South Korea	56.4	-286.0	-82.9	47.7	175.6
Taiwan	-4.9	-7.5	-1.7	1.6	-16.1
Japan	-1,717.4	-1,101.5	-176.9	-604.3	-318.8
European Union (EU-15)*	-1,094.5	-462.2	-566.4	-207.4	1,198.9
Other EU countries	-201.4	52.1	-76.4	-22.7	14.1

Source: ASEAN Statistical Yearbook, 2005, cited in Samariansyah 2006
Note:
* Austria, Belgium Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxemburg, Netherlands, Portugal, Spain, Sweden, and the UK.

Table 3.1. highlights some interesting points. Firstly, it shows that the European Union (EU) is the largest investor in Indonesia. Indeed, during the last 35 years, 90-95 percent of FDI in Indonesia originated from the EU. Secondly, investment from the EU has bounced back in the post-crisis period compared to investment from other countries, even Japan, which is often thought to be Indonesia's biggest investor. It is not clear whether this means FDI from the US is less important to Indonesia. A more detailed analysis of Indonesia's FDI situation is provided by Dr. Daniel Pambudi in Chapter 4 of this book. The domestic investment scene fares little better. In 1997, domestic investment reached a peak of Rp. 119 trillion, involving 723 projects. In 2003, domestic investment was only Rp. 50 trillion for 196 projects, whilst in 2004 it was Rp. 33.4 trillion for 158 projects. The World Investment Report 2004, produced by the United Nations Conference on Trade and Development (UNCTAD), put Indonesia the second lowest out of 140 countries in an investment performance index (Kompas 2005).

(JEXIM and US EXIM), Japan's Ministry of Trade and Industry (MITI), and the Overseas Private Investment Corporation (OPIC is a US government agency that insures private US investment) . It was to be operated by Edison Mission Energy, a US energy company, in partnership with General Electric and the Japanese firm, Mitsui. Paiton II was established in 1996 through a $ 1.7 Lawion finance package provided by US EXIM, Hermes, the German *Kreditanstaltfuerwiederaufbau (*KfW), and C&L Deutsche Revision (Germany's public investment insurance agency – analogous to the U.S. OPIC). KWU, a subsidiary of the German Siemens company, was in charge of Paiton II operations.

The projects had high level political support not just in Indonesia, but also in the US, given by prominent figures, such as the former Vice President, Dan Quayle, President Clinton, Ron Brown, Robert Rubin, Warren Christopher and Henry Kissinger. The German Federal government also supported this deal through investment guarantees.

Even before the contracts were signed, there had been sufficient reasons to doubt the soundness of the venture. For example, at the point of signing the contract for Paiton II, Indonesia was already producing a major surplus of electricity. The World Bank had even warned of overcapacities in Indonesia's electricity generation in 1994. Secondly, the Paiton II contract obligated PLN to buy electricity generated at a fixed price of 6.6 cents per KWh for 30 years – an excessive rate at the time. According to Djiteng Marsudi, the then director of PLN, he had to agree to sign the contract, since it would have been 'a suicide' if PLN had refused, given that high level political figures from the US, Germany, and Indonesia sanctioned the projects.

The Paiton I project set the tone for the other joint energy ventures that followed, in which all actors would gain financially, except PLN and the Indonesian electricity consumers. Thus, in the aftermath of the 1997 financial crisis, when Soeharto's regime ended, the Indonesian provisional government found itself embroiled in controversy about the power projects. It decided to cancel 13 of the 27 power contracts in 1998, and ordered all further projects be examined with regard to allegations of corruption. Meanwhile, PLN was plunged into debt and insolvency because its income had been in rupiah, but its expenditure was in dollars.

In the case of Paiton I, the new PLN head tried to renegotiate the price of power generated by the project. Failing this, he pressed for an annulment of the power supply contract, arguing that it was based on corruption and nepotism. PLN also went to court in Jakarta to nullify the contract. General Electrics, the operator of Paiton, and the US government that granted it a government guarantee, threatened to confiscate Indonesian property in the USA if Indonesia refused to meet the financial obligations of PLN. The German Federal Government fended off claims for damages by exerting political pressure in a similar manner. Subsequently, a joint letter from the governments of Germany, Japan, and the US was sent to the Indonesian Minister of Finance, calling on the Indonesian government to 'protect the fundamental rights of the investors'. The letter also warned that 'future investment climate of your country as well as our prospects of further co-operation are going to depend on finding a solution to the power issue'.

Under tremendous pressure from both the foreign private firms and their host government, the Indonesian government had to agree to an out-of-court settlement. In 2000, PLN had to pay about Rp. 6.5 Lawion, without receiving a single kWh of electricity as no power had been produced. The state had to bear costs of about US$ 700 million for Paiton 1, whilst having to pay a restructuring fee of US$ 900,000 per month for the next 29 years.

In the end, the risks of the power plant investment were transferred to the Indonesian state despite the fact that all players knew from the beginning about the corruption and irregularities of the project. A bad investment deal bears more risks for the state than the investors, yet all protection mechanisms at the international level exist for the investors.

Sources: Wall Street Journal (23rd December 1998), cited in Environmental Defense (2001); Der Spiegel (20/2000), Financial Times Deutschland (24th November 2000), quoted from Drillisch and Sekler (2004); Lawington (2001); Tempo Interaktif (2000); Kompas (2003).

The Paiton case is an example of an investment situation where the government of a developing country is left without protection in a bad deal. Developed countries much prefer protecting their own investors, even in dishonest deals, instead of mediating for fairer deals. Paiton was not the only case like this in Indonesia. In most power venture cases, the Indonesian government and PLN has had to deal with foreign courts, and with having their arms twisted by the Overseas Private Investment Corporation (OPIC), the US government, and the German governments who force Indonesia to cough up 'compensation'. For instance, the United Nations Commission on International Trade Law (Uncitral) ruled in favour of MidAmerican, a US energy company, contracted to build two geothermal power plants in Java. The Commission ordered Indonesia to pay US$ 572 million in compensation to MidAmerican for putting the project on hold during the economic crisis (Lawington 2001).

Despite its experience of bad investments and pressure from foreign investors, the government continues to try to attract increased FDI, mainly by formulating policies and laws that provide greater clarity about the rights and obligations of investors. The government is now in the final stages of preparing a new Investment Law to replace the outdated 1967 Foreign Investment Law and the 1968 Domestic Investment Law, both of which were amended in 1970. The new law is expected to incorporate market-oriented principles that establish basic guarantees, such as equal treatment for Indonesian and foreign investors wherever possible. Since the process of enacting a new law is lengthy, the previous administration, led by Megawati, issued an Investment Policy Statement on 11th September 2001. This policy aimed to promote and facilitate private investment. It also emphasised that investment is an important means to achieve employment creation, the transfer of technology and skills, and export growth. Under the current administration of Susilo Bambang Yudhoyono, a new policy package, in the form of Presidential Instruction No. 3 / 2006, was issued in March 2006 to improve the investment climate. The instruction sets time-bound targets, assigning all economic-related ministers the responsibility for all targets under five categories: (i) general investment policies, (ii) customs, (iii) tax, (iv) labour policy, and (v) small and medium enterprises (SME) policy (World Bank 2006).

Despite the introduction of such measures and the presence of various indications that foreign and domestic investments are growing, some weaknesses in Indonesia's micro investment climate have yet to be addressed. Businesses continue to face high costs due to corruption, a weak legal system, a deteriorating infrastructure, poor tax and customs administration, rigid labour regulations, complex licensing and approval procedures, and a mushrooming of local *nuisance* taxes (World Bank, 2004). Dr. Iman Sugema, the Director of the Institute for Development and the Economics of Finance (INDEF), has stated in an interview that the most important aspect of investment is the confidence of domestic investors.[3] If domestic investors are not willing to invest in Indonesia, why should foreign investors be attracted to invest?

As mentioned earlier, the government has drafted a new Investment Law, which is being deliberated by the People's Representatives Assembly (DPR – *Dewan Perwakilan Rakyat*). Key elements of the Law, which have implications for the investment chapter in the proposed USIFTA, are as follows:

a. Investment is defined as assets in monetary and non-monetary forms owned by the investors;
b. The objectives of the investment law are to increase economic growth, create employment, enhance the competitiveness of national enterprises, increase the welfare of the people, and to increase national technological capacity;
c. The Law provides for the equal treatment of foreign and national investors, and to foreign investors from all countries, except those countries that have special privileges based on a treaty with Indonesia; [4]
d. Government will not nationalise or take over investment

3 An interview was conducted with Dr. Imam Sugema, the Director of INDEF, on 1st December 2006, in Jakarta.

4 In the draft of the Law, *special privilege* applies to a customs unit, a free trade area, a common market, or a monetary union that can be achieved through a bilateral, regional, or multilateral treaty between Indonesia and its trade partners. These treaties generally contain special investment privileges.

ownership, except based on existing laws; and will provide compensation based on market value;

e. Investors can transfer assets, based on existing laws;
f. Dispute settlement is through arbitration, the alternative dispute settlement system or the court, based on existing laws;
g. Investors must prioritise the labour of Indonesian nationals, although they can hire foreign labour for specific echelons and skill-based work, based on existing laws;
h. Investment is open to all sectors except those declared to be closed, or declared to be open with specific requirements. The negative list will be determined through another law;
i. A dispute with foreign investors that cannot be settled amicably, can be brought to international arbitration;
j. The government will determine sectors reserved for SMEs, and sectors that are open to larger enterprises, but subject to their cooperation with SMEs.

The new Investment Law seems to define investment more broadly. By defining it as a non-monetary asset, the Law could strengthen certain areas of investment, such as intellectual property rights. The Law also accommodates many of the principles that would guarantee greater investment liberalisation, and more protection for investors. The new Investment Law has become a subject of debate at the DPR, and its finalisation has been postponed several times. Due to weak institutional arrangements and unresolved aspects of decentralisation, some parties have asked that the Law be carefully discussed. A major political party in the parliament, the Indonesian Democratic Party for Struggle (PDI-P – *Partai Demokrasi Indonesia untuk Perjuangan*), for instance, has suggested that ideas such as national economic recovery and growth, the increase of national technological competence and capacity, and the integration of national industrial development, be incorporated into the Law's objectives. This Party also recommends including an article on penalties for legal violations on the part of investors, and an article that outlines the requirements investors have to fulfil, including a guarantee that multiplier effects will emerge from foreign investment (PDI Perjuangan 2006).

The Association of Regional Parliaments (*Asosiasi DPRD Seluruh* Indonesia) and the Association of Regencies (BKKSI - *Badan Kerjasama Kabupaten Seluruh Indonesia*), on the other hand, insist that the division of tasks, responsibilities, and benefits between regional and central governments should be clarified first. They also want to see an investment law that guarantees local small and medium industries and / or enterprises will not be marginalised by large scale investment (Adkasi 2006; BKKSI 2006). These associations and some major political parties have emphasised the need to allocate sectors that would be open only to SMEs, or open to large investors on the condition that they cooperate with SMEs. If these conditions are to be accommodated in the new investment law, this law is unlikely to be compatible with an investment chapter in any proposed USIFTA. The main objective of investment should be national development, but foreign investment could also jeopardise Indonesia's future, especially if such investment came through a BFTA with developed countries, such as the US. Indonesian negotiators and government officials are waiting for the investment Law to be finalised and made a law that will facilitate BFTA negotiations. However, as Dr. Sugema has pointed out, what is also of great importance is just *how* Indonesia will implement this new law.

Investment in the US

The investment scene in the US comprises two aspects: (1) FDI in the US; (2) and FDI abroad. FDI in the United States declined sharply from a record $ 300 Lawion in 2000 to about $ 100 Lawion in 2004 (Jackson 2005).[5] The total amount of investment spent in the US by foreign firms also fell to 3.5 percent in 2003, from 19 percent in 2000. Like Indonesia, in 2002, FDI in the US also fell to levels not experienced since 1994, as foreign investors faced a number of uncertainties. FDI increased again by 20 percent in 2005, with new investment amounting to $ 129 Lawion. The United Kingdom (UK) is the largest foreign direct

5 Unless otherwise specified, the data for this part is obtained from Jackson (2005), but analysis is by the author.

investor in the U.S., followed by France, Holland, and Japan. There is minimal investment from developing countries. Indeed, investment from developed economies accounts for 95 percent of all FDI in the US. Such investment is predominately in the manufacturing sector, which accounts for about 35 percent of total FDI in the US. Even if Indonesian goods gain access to the US market, they will face stiff competition.

FDI is highly sought after by the US State and local governments as a tool to create additional jobs. Similarly, many in the US Congress encourage such investment to offset the perceived negative economic effects of US firms investing abroad. It is interesting to note that by the end of 2002, foreign firms employed only 5.4 million Americans, or less than 4 percent of the total US civilian labour force. Employment creation is the single most important objective in US investment policy, but few studies have analysed whether FDI, indeed, creates employment at the local level.[6] The US is both the largest investor abroad and the largest recipient of FDI in the world. The United Nations (UN) has indicated that US firms are the largest foreign direct investors in the world, which explains why many developing countries, including Indonesia, are seeking to attract US investors to their country. However, 70 percent of US foreign direct investment is concentrated in high income, developed countries (Jackson 2006). Europe alone accounts for over a half of all US FDI abroad, or about US$ 1.1 trillion.

According to the US Department of Commerce, US FDI abroad dropped sharply from US$ 252 Lawion in 2004 to US$ 21 Lawion in 2005. This drop reflects the erratic manner of FDI, which is caused by several factors. For instance, relative rates of growth between US and foreign economies determine the direction and magnitude of FDI flows. Relative rates of inflation, interest rates, and expectations about the performance of national economies are equally important factors that determine the flows of FDI. In the US, investment funds have shifted

6 Such an analysis is beyond the scope of this paper. However, it is clear that the US, as much as Indonesia, seeks FDI as a tool to create more employment. Indonesia's desire to create employment through FDI should not be perceived as putting conditionalities on investors.

from extractive, processing, and manufacturing industries towards high technology services and financial industries. In the same manner, US FDI abroad is focused less on the extractive, processing, and basic manufacturing industries in developing countries, and more on the high technology, finance, and services industries located in highly-developed countries. Developing countries seeking to increase US FDI need to take this into account. Indonesia hopes that US investors will invest in, amongst other things, mining, oil and gas, and the energy and chemical industries sectors (Depdag 2006). As with FDI into the US, the issue of employment is also important in terms of US FDI abroad. Some observers believe US direct investment abroad is harmful to US workers because it shifts jobs abroad (Jackson 2006). Whilst this is partly true, the bulk of US investment abroad does go to developed countries where wages, markets, industries, and consumers' tastes are similar to those in the United States.

US - Indonesia trade and investment relations

Historically, the US has a major interest in the Indonesian mining sector. The US company, Freeport McMoRan, was the first to invest in a copper mining venture in Indonesia in 1967, immediately after the fall of the nationalistic Soekarno and the rise of Soeharto. Freeport McMoRan invested in copper in the Jayawijaya Mountains of West Papua, but ended up controlling the largest gold mine in the world. It has been operating for more than 30 years, with an annual revenue of US$ 1.5 Lawion. It has led to a myriad of ecological and social problems. Freeport's venture in West Papua was guaranteed by the Multilateral Investment Guarantee Agency (MIGA).[7] However, many MIGA guaranteed projects have been

7 MIGA is one of the private sector arms of the World Bank Group, which provides security guarantees in politically unstable countries. MIGA provides insurance for projects against: (i) any losses an investor may experience if local currency cannot be converted into foreign currency and taken outside the host country; (ii) losses due to host government actions that reduce or end investors' control over or rights to the insured investment, such as nationalisation or confiscation; (iii) losses due to breaches of contracts; and (iv) losses caused by war and civil disturbance. Further details of (the) MIGA can be found in the official website of Down to Earth at: http://dte.gn.apc.org/Af16.htm

criticised by civil society for the ecological and social damage they cause. Indonesian environmental groups have sued the company in national courts for environmental damages.[8] Indonesian civil society groups also approached MIGA officials about the damage, and the fact that MIGA had guaranteed the mine. In 1996, whilst MIGA was in the process of sending an investigative team, Freeport McMoRan decided to cancel the contract. By doing so, the company avoided having to comply with the World Bank's environmental standard, and evaded the MIGA-led investigation (Down to Earth 2001). Other mining companies, such as Newmont, have also been involved in similar controversies over environmental damages.

Currently, the US is the fifth largest investor in Indonesia, after Japan, UK, Singapore, and Taiwan - Hong Kong.[9] According to the Investment Coordinating Board (BKPM – *Badan Koordinasi Penanaman Modal*)), the cumulative value of approved US investment in Indonesia from 1967 to July 2000 was US$ 10,449.2 million. Based on data from the US Department of Commerce, there was a divestment in US investment in 2002 to the order of US$ 600 million, from US$ 8.23 Lawion in 2001 to US$ 7.55 Lawion in 2002, but this increased to US$ 10.39 Lawion in 2003. 79.4 percent of this investment was in the oil and gas sector (Kompas 2005). Indonesia and the US signed a Trade and Investment Framework Agreement (TIFA) in 1996. This TIFA is thus far the only bilateral trade and investment treaty between the two countries, and it aims to improve dialogue through a Trade and Investment Council (TIC). According to Dr. Hadi Soesastro, the Executive Director of the Centre for Strategic and International Studies (CSIS), Indonesia was one of the first countries to sign a TIFA with the US.[10] A TIFA is not a forum for negotiation, but a forum for consultation. Such consultation lay dormant during the immediate post-crisis period, but was revived in

8 Conflicts and environmental damages involving Freeport in Papua are well-documented in, for example, Leith (2003).

9 This data may be slightly different from Table 1, because the source is different.

10 An interview was conducted with Dr. Hadi Soesastro, Executive Director of CSIS, on 19th October 2006, in Jakarta.

2005. Since then, the two parties meet about four times a year to discuss wide-ranging trade and investment-related issues that will hopefully be of benefit to both countries. In a TIFA meeting held in April 2006, the Indonesian Minister of Trade, Dr. Mari Pangestu, stated that Indonesia's priority was development cooperation, focusing on human resources development, as an integral part of the country's trade and investment strategy. Indonesia was also concerned about sanitary and phytosanitary issues in agricultural products exported to the US, as well as information on the quality of products wanted by the US market.[11]

Of primary concern to the US, however, were issues around intellectual property rights (IPR), effective investment laws and their implementation. Although the Indonesian trade delegation tried hard to convince the US team about their country's commitment to protect IPR effectively (Depdag 2006), it was clear that the US was none too happy with the implementation of IP laws in Indonesia. However, during the visit of the Indonesian Vice-President, Jusuf Kalla, to Washington on September 2006, it was agreed that the TIFA was a building block to establishing more comprehensive trade and investment cooperation, such as a FTA.[12] Although the US expressed interest in starting negotiations on a bilateral investment treaty (BIT), and had offered a template, the Indonesian government felt that the conditions offered in the US proposal were too difficult for Indonesia to meet. Apart from that, Indonesia was still in the process of conducting a cost-benefit analysis of the proposed USIFTA and BIT (Depdag 2006).

Key investment issues in a USIFTA

As mentioned earlier, there is no legal text for a USIFTA yet. However, the US has already signed many BFTAs with other countries, such as (i.e. with) Singapore, to name one country in the Southeast Asian

11 As quoted from Depdag (2006).

12 An interview was conducted with Halida Miljani, an Expert Staff to the Minister of Trade of the Republic of Indonesia, on 18th December 2006, in Jakarta.

region. According to Rizar Nazaroedin from the Investment Coordinating Board (BKPM), the US has a standard template for its FTA negotiations, most of which is derived from the North American Free Trade Agreement (NAFTA). Indonesia is not expected to draft the principles and modalities of the proposed USIFTA, but is expected to negotiate the template already prepared by the US government. A comparison of the legal texts of the US-Chile Free Trade Agreement (USCFTA), the US-Singapore Free Trade Agreement (USSFTA), and the US – Central American Free Trade Area (CAFTA) Free Trade Agreement reveal few significant differences between the agreements (Thanadsillapakul 2006). Most of the articles in these agreements were shuffled around, but the essence was the same. Investment chapters based on the US template are starting to appear in many countries' investment laws. Some of the key provisions in US-led BFTAs are discussed below.

Definition, scope and coverage

In the US-Singapore Free Trade Agreement (USSFTA), investment is defined broadly as 'every asset owned or controlled, directly or indirectly, by an investor'. This definition is further specified to include various forms, from enterprise to shares, bonds, futures, IPR, and licenses. The word *investment* in the USSFTA also includes 'other tangible or intangible, movable or immovable property, and related property rights, such as leases, mortgages, liens, and pledges'. In essence, it is a very broad definition that can be interpreted in numerous ways, and, as such, could limit the authority of a host country to control foreign investments. Meanwhile, an investor is defined as an entity of a Party that is 'seeking to make, is making, or has made an investment in the territory of the other Party'. In other words, the host country is obliged to protect pre-entry establishment, or the 'would be investors'. During the late 1980s, the pre-entry establishment provision was only available in the Canada – US Free Trade Agreement (CUSFTA) (Sornarajah 2004), but now features in many investment chapters of US-led FTAs.

An investment chapter for the US applies to everything that falls within a broad definition of investment, or what the US refers to as *covered investment*. Most developing countries, such as Thailand, however, prefer that an investment chapter only applies to direct investment. Similarly,

the proposed new Investment Law of Indonesia defines investment as 'an activity of investing to do business in the territory of the Republic of Indonesia', and, thus, it does not protect pre-entry establishments. Developing countries generally find it difficult to cope with the impacts of the rules and regulations that protect and / or control, for example, portfolio investments. Such definitions are important since they oblige states to protect the rights of investors.

Performance and human resources requirements

The provisions in the legal texts of the USSFTA and the proposed US-Thailand FTA (USTFTA) prohibit a Party from enforcing certain requirements, such as the imposition of export quota and domestic content, and the restriction of sales of products and services from the investment in its territory by relating such sales to the volume or value of exports or foreign exchange earnings. Most importantly, a Party may not impose requirements for technology transfer, production processes, or other proprietary knowledge to a person in its territory. Another provision forbids a Party from requiring an enterprise to appoint senior management of any nationality, but allows for a majority of the board of directors to be of a particular nationality as long as this requirement does not impair the ability of the investor to control the investment. These provisions are exempted for investments that are in the Negative List[13] of a Party, which includes those sectors that are not open, partially open, or open with conditions for foreign investment. Even with the exceptions

13 A Negative List is a method of liberalisation in the service sector. This method is used in some of the scheduled commitments under the General Agreement on Trade in Services (GATS). These lists are generally composed of service activities that a country agrees will be covered in the liberalisation process, unless they are listed as subject to some limitations on market access and national treatment. The disadvantage of this method is that all new services not previously listed would automatically undergo liberalisation. This is developed countries' preferred method of negotiation regarding trade in services. There is also a so-called *Positive List* in service sector liberalisation. Service sectors that are listed in a Positive List are sectors not subject to the liberalisation process. Most countries, particularly developing ones, have made such lists.

in a so-called Negative List, such provisions can be imposed out with the development requirements of the host country (i.e. the host country is allowed to export a certain percentage of its production to earn foreign exchange, whilst foreign firms are obliged to employ local labour and to transfer skills and technology to the host country) (Sornarajah 2004). Such provisions do not conform to the objectives of the new Indonesian Investment Law, in that they oppose development objectives by attracting foreign investment into the country.

Transfer, expropriation and compensation

Transfer, expropriation and compensation are provisions relating to the economic and political dimension of foreign investment in which investors are granted all rights, whilst the host country is provided with minimum (or virtually no) right to regulate investment for development purposes. The first provision, or *transfer*, obliges a Party to permit all transfers to be made freely by investors in and out of the host country. This includes the transfers of profits, capital gains, and contributions to capital. In the past, host country governments often restricted the repatriation of profits and other forms of transfer. The repatriation of profits and capital generally worsens the economy of a country hit by a financial crisis (Sornarajah 2004). Investors usually leave a crisis-hit country at the exact time when that country is in need of capital inflows. This also effectively prohibits capital control in developing countries, and generally allows a surge of *hot short term* money to flow in. Such surges have been identified as one of the major causes of the Asian financial crisis.

With regard to *expropriation*, or *nationalisation*, all US FTAs have a provision which states that neither party in a trade deal should expropriate or nationalise a covered investment 'either directly or indirectly through measures equivalent to expropriation or nationalization'. The word *indirectly* poses a problem for developing countries because it can be interpreted very widely. Any regulatory or policy measure that is deemed by investors to be 'indirect expropriation' will be contested. This can include confiscatory taxation, environmental measures, labour laws or development policies that may impact on the profitability of the investment. As stated by Nazaroedin (pers com 2006), an investor will

ask for *compensation* for any government intervention that impairs an enterprise and incurs losses in an investing company, which is termed indirect expropriation. This is then linked to the international dispute settlement system, where investors can sue the host government directly. Indonesia will definitely face such difficulties, as the Paiton case indicates. As Nazaroedin has pointed out, the decision as to whether a measure is indirect or direct expropriation is decided by a body outside the country, which is unacceptable.

Expropriation may also be conducted for a public purpose, in a non-discriminatory manner, with due process of law and payment of prompt, adequate and effective compensation. The compensation must be paid without delay, and must be equivalent to the market value immediately *before* the expropriation took place. In addition, compensation must be fully realisable and freely transferable, and interest should be charged at a commercially reasonable rate (see Art. 15.6.3 and Art. 15.6.4 in the USSFTA). The Paiton I and II cases illustrate the likely scenario with regard to appropriation and compensation for Indonesia. The Paiton project was established on the corruption of a former government, and offered unreasonable advantages to the US government. When Indonesia was hit by the financial crisis, the government could not cancel the project without providing compensation to the investors. If the Indonesian government were to pursue the appropriation process, it would not only raise criticism from foreign investors, but also from the governments of the countries in which these investors are based. Indonesia's FTA with the US is likely to institutionalise the ways in which foreign investors and governments exert pressure on trade partners.

Investor-state dispute settlement

Investment dispute is possibly the most serious issue that developing countries have to face under a US-led BFTA. If the dispute is not settled through consultation and negotiation, the investment chapter in US-led BFTAs rules in the dispute settlement through the disputing Parties' competent judicial or administrative authority, or through the International Centre for the Settlement of Investment Disputes (ICSID). Most investors opt for the ICSID, as foreign investors tend to lack confidence in host countries' judicial systems. It is interesting to note that

the US-Australia FTA (USAFTA) does not include a specific provision on investor-state dispute settlements. This is probably because the US and Australia are developed countries. It is also likely that Indonesia will refuse any such provision in the investment chapter of the proposed USIFTA.

The USSFTA contains details on how to submit to arbitration, the automatic consent of each Party to arbitration,[14] the selection of arbitrators, transparent tribunal proceedings, and the mechanism for granting awards as decided by the tribunal. Such legal proceedings could become a heavy economic burden on a developing state that cannot afford expensive lawyers, etc. Some 42 investor-state disputes have arisen out of the Chapter 11 (Investor-State Dispute Settlement) of the NAFTA. These cases were filed based on public policies that investors perceived as impacting on their investments, and were settled using a closed system where public accountability has no place (Public Citizen 2005). In such a context, expropriation is defined as including *regulatory takings*, or loss of profit or revenue due to an application for or change in government regulation of policy. Investors often take a host state to tribunal for this reason. The mere threat of this is enough to make the government of a developing country government refrain from making policies in favour of the public, development, and the environment. In other words, governments lose some control over policy. Economic repercussions often follow, as in the Paiton case. The failure of the Indonesian government to pay compensation, as specified by the tribunal, the other party, or the US, leads to tariffs being imposed on Indonesian exports. The Paiton case illustrates how vulnerable Indonesia is *vis-à-vis* foreign investors and governments. If Indonesia signs a USIFTA, such regulations will put the Indonesian government and its people under institutionalised pressure. Such issues need to be further scrutinised within the framework of BFTAs. Many aspects of investment chapters are linked to the preamble of the treaties themselves, and to chapters such as services, financial services and IPRs,[15] the discussion of which

14 This means that the host government is obliged to attend an international tribunal.

15 See Chapter 6 for an analysis of IPR.

are not within the scope of this chapter, although they can seriously impact health and the environment.

Projected impacts on development

As with most bilateral free trade agreements (BFTAs), investment arrangements (either through BFTAs or bilateral investment treaties (BITs)) are usually pursued by unequal partners. Most bilateral investment arrangements are agreed by a capital exporting country and a developing state that is keen to attract capital. Such treaties are signed under the assumption that they will result in increased foreign investment. However, these treaties do not generally contain any firm obligation on the part of the capital exporting state to ensure such flows take place (Sornarajah 2004). Despite this, many developing countries insist on locking themselves into an investment arrangement with developed countries for two main reasons. Firstly, developing countries wish to secure the promise of increased foreign investment to generate employment and to increase production capacity. Secondly, investment liberalisation is seen as a way to expand market access to developed countries. In other words, developing countries hope that the presence of developed countries in their countries will be compensated by the developed countries opening up their markets to developing countries' exports. These hopes are yet to be realised in many US-led BFTAs. According to a prominent figure in Indonesian trade circles, Halida Miljani, aside from the issue of market access, Indonesia's main objective in negotiating FTAs or economic partnership agreements (EPA) is investment.[16] The most important issue for Indonesia today is how to manage foreign investments effectively so that they serve the country's national development goals. As most BFTAs are conducted between a developed country and a developing country, it is imperative that these agreements integrate co-operation and capacity- building measures, particularly in the area of human resources development.

16 An interview was conducted with Halida Miljani, Expert Staff to the Minister of Trade, on 18th December 2006, in Jakarta.

Does signing an investment treaty lead to increased investment flows?

As mentioned before, an investment chapter in a US-led BFTA does not usually contain any obligation on the part of the capital-exporting country to ensure investment flows into the capital-importing country. Yet Indonesia expects its BFTA with the US will increase the flow of US capital into the country, an expectation that may turn out to be ill-founded. A 2003 (study by the) World Bank study examined the experiences of 20 developing countries between 1980 and 2000, and found that agreements seeking to provide assurances to foreign investors did not, in themselves, stimulate additional investment. Instead, market size and macroeconomic stability were key drivers to foreign investment. Another study by researchers at Yale University compared investment flows from the US to countries that did and did not have investment agreements with the US. They found that countries that had an investment treaty with the US attracted less investment. The results of their study 'indicate that signing an investment treaty with the US does not correspond to increased FDI flows' (Gallaghar 2005).

Dr. Iman Sugema, from the Institute for Development and Economics of Finance (INDEF), has also confirmed that most investments from developed countries are going to other developed countries. He and Rizar Nazaroedin, from the Investment Co-ordinating Board (BKPM), could not provide a conclusive answer when asked how much investment is expected to flow to Indonesia from the US once a USIFTA is signed. Whilst Dr. Sugema doubted that there would be an increase in US investment in the country, Nazaroedin argued that investment flows depended on the private sectors both in the US and in Indonesia. According to Nazaroedin, increased flows of investment would probably only occur in the sectors in which the US has economic interests, such as mining and energy. Meanwhile, Sofyan Wanandi, from the Association of Indonesian Entrepreneurs (APINDO – *Asosiasi Pengusaha Indonesia*), argued that Indonesia cannot expect the US to invest significantly in the manufacturing sector.[17] Apart from the mining sector, the US might also be interested in the Indonesian service sector, and the information and technology (IT) industry. Yet there is no guarantee that a

17 An interview was conducted with Sofjan Wanandi, Chairman of APINDO, on 12th October 2006, in Jakarta.

USIFTA, which is likely to contain a comprehensive investment chapter, will increase investment flows from the US to Indonesia. Nonetheless, Indonesia's proposed new Investment Law is still geared towards fulfilling the principles and modalities of investment liberalisation that are contained in US investment treaty templates.

Will Indonesia's market access to the US increase after signing a USIFTA?

Many developing countries hope to gain greater access to the US market through BFTAs. However, a study conducted by Francis and Kallummal (2006) shows that the US is not a freely accessibly market. In the case of the USSFTA, Singapore was forced to guarantee tariff elimination on all US products immediately after the agreement came into effect. On the other hand, the US agreed to eliminate most, but not all, tariffs against Singapore's exports, although any remaining tariffs would be phased out within 3-10 years after signing the agreement. In the case of the US-Thailand FTA (USTFTA), Francis and Kallummal pointed out that the agreement would offer Thailand only small margins of tariff preference. It is thus unlikely that a USTFTA will make any difference to Thailand's access to the US market. The authors demonstrate how the US picks and chooses the products it wants from its trade partners, whilst demanding almost total liberalisation for entry of its own products. Non-tariff measures, such as the technical barrier to trade (TBT) and Sanitary and Phytosanitary measures, are likely to limit Thai exports to the US market. The US also provides significant agricultural subsidies for its farmers and imposes high import tariffs which makes it difficult for developing countries, such as Indonesia, to penetrate the US agricultural sector.

The tariff elimination scheme in BFTAs also allows the US to gain higher market access. For instance, US exports to Chile and Singapore grew by US$ 4 Lawion in the first year after BFTAs were implemented. In fact, Singapore's trade deficit with the US doubled during the first year of the USSFTA (CAFTA Policy Brief 2005).[18] There is no clear

18 As quoted in Pal and Ghosh (2006).

pattern of FTAs increasing market share in the US. In fact, the US' old FTA partners, such as Mexico and Canada, and new partners, such as Australia and Singapore, have actually lost market shares in the US. On the other hand, for some new BFTA partners, such as Chile, market share in the US has been maintained or improved. More interestingly, however, some non-(B)FTA partners of the US, such as India and China, have managed to increase their market share in the US. Indeed, as Sugema has pointed out, in the absence of the appropriate business networking, an (B)FTA is unlikely to increase developing countries' market access to the US. At the end of the day, the decisions as to when and how to expand a business activity must be made by the producers / exporters. The role of the government is to help improve the capacity of national industries. Indonesia's export interests in the US include many sectors that are protected by the US, such as agriculture, fisheries, textiles, and the manufacturing industry. In order to improve the competitiveness of Indonesia's exports in the US, it is vital that technical issues, such as quality, packaging, and shipment, are addressed and standards improved.

The space to develop?

Regardless of the volume and value of investment flowing into Indonesia after signing a USIFTA, it is imperative to examine the potential costs and gains the treaty would expose the country to. Such issues depend greatly on the purpose behind attracting more foreign investment in the first place. The 2001 Investment Policy and the proposed Investment Law stipulate that investment is needed to increase the transfer of technology and skills, increase employment, and to achieve export growth. If these needs are fulfilled, then national development in Indonesia will proceed. However, such elements are often suppressed by US-led BFTAs. The transfer of technology, for example, is unlikely to occur even with increased investment flows to Indonesia. Some interviewees, such as Dr. Sugema and Nazaroedin, were also doubtful whether increased investment would generate employment. Foreign investment will not benefit Indonesia if, for instance, the investment brings three US consultants to work in a small office In Jakarta. Indonesia requires massive business investment, not only to increase employment, but also to drive the economy. Moreover, Indonesian bureaucrats are often overconfident about the benefits of foreign investment. The flow

of foreign investment is unlikely to yield any benefits if Indonesian business sectors are unable to manage the spill-overs from this economic activity.[19] The government must also avoid giving special treatment to foreign investors to the detriment of local investors. In addition, foreign investment should not displace the activities of small economic actors. The emergence of hypermarkets, for instance, has challenged the well-being of these small economic actors.

Finally, how can Indonesia experience revenue gains from exports if the investment chapter in the proposed USIFTA prohibits a country from imposing the necessary requirements? The failure of foreign investment to generate technology transfer, employment creation, and revenue generation ends up jeopardising rather than improving national welfare. Moreover, Indonesia is likely to lose some of its freedom to formulate policy in its national development agenda, even if investment does increase. Such freedom is especially threatened by the rules on Investor-State dispute settlements at a time when Indonesia is already vulnerable to pressure from multinational corporations and their home country governments.

Will domestic reforms take place under the proposed USIFTA?

It is clear that Indonesia requires domestic economic reforms, with or without a USIFTA. The lead negotiator in the Indonesia-Japan Economic Partnership Agreement (IJEPA), Soemadi Brotodiningrat (2006), has argued that BFTAs can be used to expedite and improve the process of domestic economic reform. Others commentators from the Indonesian government and civil society groups contend that BFTAs can also be used as a mechanism to solve certain bilateral trade problems, creating incentives for domestic economic players, as well as pushing the government to undertake more serious domestic reforms and enforce the law more effectively. However, such improvements are not achieved

19 The economic modelling analysis in Chapter 4 also shows that increased foreign investment does not improve, but actually lowers household income levels.

only by signing up to BFTAs. It is imperative that fundamental economic reform is implemented and that domestic economic problems, such as corruption, data inaccuracy, etc., are solved prior to signing. The issue of accurate data, in particular, deserves special attention. In most developed countries, business associations and academic think-tanks carry out comprehensive studies to obtain the necessary data to support their governments' trade policies. This is not the case in Indonesia where the government often creates policies without the support of adequate and reliable data. Merely signing a USIFTA is no guarantee of improvements in the Indonesian domestic economy.

Concluding remarks: elements of a fair investment treaty

This critique of the current mode of bilateral investment treaty, either in itself or as part of a BFTA, is not intended to suggest that countries such as Indonesia should cease to attract foreign investment. Any investment treaty must instead be tested against the development goals of developing countries. Firstly, a developing country, in this case Indonesia, must really determine whether it needs increased FDI flows. Some countries secure domestic capital from alternative sources, such as through domestic savings. Secondly, if Indonesia does decide it needs FDI, then it must define the type of FDI and the sectors involved, so that the economy grows through employment creation and the transfer of technology. Funding for development through export growth needs to be mobilised, with the absolute goals to alleviate poverty and improve the national economy. An investment treaty should be a tool to achieve these development goals, developed within a framework that benefits investors as well.

To protect Indonesian national interests, any bilateral investment treaty that Indonesia wishes to engage in should contain the following elements. These elements must firstly be enshrined in national investment laws and regulations which serve as the basis for negotiating BFTAs or BITs.

1. A balance between investors' rights to profit and the government's rights to protect national interests, the environment, and its people;
2. The protection of certain sectors deemed sensitive by a country, including infant and small scale industries, and the agricultural sector, which provides a livelihood to a large number of farmers;
3. The promotion of investment in areas that are in need of capital inflow;
4. The promotion of investment in sectors that would provide the most employment;
5. Formulation of rules that would balance exports for generating foreign exchange against supplying the domestic market, and that regulate capital flows to avoid sudden inflow and outflow of capital;
6. The promotion of technology and skills transfer, as opposed to strict IPR protection;
7. Cooperation in building production capacity to fulfil market requirements for quality and safety;
8. Disincentives for environmental damage, but incentives for sound environmental management.

Investment is a risky business, not just for investors, but for host countries and their people. Whilst investors have many guarantee mechanisms when investing in countries like Indonesia, ranging from MIGA to insurance and guarantees from their own governments, the host country and its people are without any guarantee or protection against bad investors and unfair deals. Ultimately, if a *win-win situation* is to be achieved, the profit from, as well as the risk of, investment must be shared equally between the investors and the host country. Investment should never be a case of *socialising risks, and privatising profits*; rather it should be regulated and managed to ensure corporate responsibility whilst achieving common development goals.

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