

NUISANCE OR NECESSITY?
REGIONAL AUTONOMY AND THE MINING INDUSTRY IN INDONESIA¹

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Introduction

There is little doubt that mining has played a significant role in Indonesia's economic development. The abundance of natural resources and the extractive industries in particular contributed 6.2% of the GDP growth in the first quarter of 2007.² Despite this, in recent times the economic benefit of mining to the Indonesian economy has waned. This is primarily because of the Southeast Asian monetary crisis in 1997 and the political instability following the resignation of President Soeharto in 1998. Unfortunately the situation has been compounded by the passing of two key acts in 1999 which began the process of decentralisation: one allowed for the devolution of political power and the other for the redistribution of fiscal authority to Indonesia's regional and district governments.³ While this has appeased public demands for a more accountable and

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² R. McLeod, 'Survey of Recent Developments', *Bulletin of Indonesian Economic Studies*, vol. 44, no. 2, 2008, p. 185.

³ For the purpose of this paper, regional government refers to governments at the provincial and district level. In understanding how these terms are used it is important to be aware of how the administrative terminology of Indonesia changed with the reforms that began in 2001. Before the reforms, there was no genuine concept of 'regional government'. Rather all organs of government at the *kabupaten* and *kota* level were really 'agents' of the central government. Hence in the pre-reform period one talked about only the

transparent political system it has also resulted in an unstable investment climate. This has been especially acute in the area of natural resource management, a sector of vital importance for Indonesia's economy. The main reason for this, as we shall see, is the resilience of Sukarno and Soeharto era political institutions and the elites that continue to control them. In short, because a long-standing oligarchy continues to direct much of Indonesia's political decision-making and economic apparatus, it has managed to distort initiatives designed to free up inefficiencies and empower groups that have traditionally been excluded from mainstream politics and economics.⁴ This is particularly clear in the mining sector which, if not subjected to better oversight and prudential regulation, could presage a period of significant long-term suffering across the archipelago.

The evolution of Indonesia's highly centralised political and fiscal system is well known and documented elsewhere and does not merit more than a brief discussion in this paper.⁵ Instead, I begin below with an explanation of the need for political and fiscal decentralisation, how it began in 1999 and the manner in which the process has evolved.

Part 1: The origins of Indonesia's reforms

For most of its post-independence period Indonesia has loomed for many scholars as an example of the challenge faced by post-colonial states to uphold political legitimacy in a globalised civil society.⁶ Since the inception of the Republic in 1945⁷ the Indonesian

central government or provincial governments. After the reforms the concept of a genuine 'district government' emerged for the first time. The term 'district government' now refers to the *kabupatens* and *kotas* while the term 'regional government' refers to the provinces and the districts. These concepts coincide with former terms but the meanings have changed. W. Jaya, 'An Institutional Approach to Fiscal Decentralisation in Indonesia: An assessment of the regional autonomy reforms after 1999', Ph.D. thesis, Monash University, 2008, p. 17.

⁴ R. Robison & V. Hadiz *Reorganising Power in Indonesia: The Politics of Oligarchy in an Age of Markets* Routledge, New York, 2004. See also, H. Ross McLeod and A. MacIntyre (eds.) *Indonesia: Democracy and the Promise of Good Governance*, Institute of Southeast Asian Studies, Singapore, 2007.

⁵ On the evolution of political and fiscal centralisation in Indonesia prior to 1999 see for example: R. Cribb, 'Nation: Making Indonesia', in D. Emmerson, *Indonesia Beyond Soeharto: Polity, economy, society, transition*, ME Sharpe, New York, 1999, p. 16; R. McVey, 'Building Behemoth: Indonesian constructions of the nation-state', in D. Lev, R. McVey, *Making Indonesia*, Cornell Southeast Asia Program, Ithaca, 1996; L. Suryadinata 'Politics in Indonesian Parliament, 1966-1985' *Asian Journal of Social Science*, vol. 15, no. 1, 1983, pp. 35-52; P. Guinness, 'Local Society And Culture' in H. Hill (ed.), *Indonesia's New Order: The Dynamics Of Socio-Economic Transformation*, Allen & Unwin, St Leonards, 1994, pp. 273-75.

⁶ See P. Chatterjee, *The Politics of the Governed: Reflections on Popular Politics in Most of the World* Columbia University Press, New York, 2008; J. Millikan & K. Kruase 'State Failure, State Collapse, and State Reconstruction: Concepts, Lessons and Strategies' *Development and Change*, vol. 33, no. 5, 2002,

government conceived and implemented policies that sustained a united, if somewhat oppressed population and a concentrated source of political power. Indonesia experienced two consecutive but ideologically divergent authoritarian regimes: the first under President Sukarno (1949 – 1965) and the second under President Soeharto (1966 – 1997). From this carefully constructed state, a centralised, economically powerful and yet democratically weak Republic of Indonesia emerged.

The need for unity, combined with the desire for modernisation, was not an unusual feature of post-colonial states, many of which were characterised by the colonial legacies of an overly influential military, hotly contested claims to political sovereignty, and an abundance of excessively ambitious presidential hopefuls.⁸ Thus, following independence an immediate task confronting Indonesia's new leaders was to build a loyal following by encouraging the population to focus on the nation rather than on their own parochial and highly localised interests. Only then would they supplant sub-national loyalties couched in religious, tribal or other ethnic forms with a modern form of nationalist loyalty.⁹

The subjugation of local interests for the greater good of the nation was encouraged once again following the attempted coup in 1965 which would see the shift of power from Sukarno to President Soeharto. The first priority for Soeharto and his 'New Order' government was managing the myriad of social conflicts and problems that had erupted during the final years of Sukarno's tenure. The New Order revived a number of policies that had been established by Sukarno in an effort to guarantee widespread endorsement and protect the government from popular mobilisation.

In particular, Soeharto's 'authoritarian corporatism' provided significant market opportunities but only to the landed and entrepreneurial classes that evinced a willingness to do the regime's bidding. Typically there were many who wished to do so, and to enjoy

pp.753-775; M. Beeson, 'Sovereignty Under Siege: Globalisation and the State in Southeast Asia' *Third World Quarterly*, vol. 24, no. 2, 2003, pp. 357-373.

⁷ Independence from the Dutch was not officially sanctioned until 1949.

⁸ U. Sundhaussen, 'Indonesia: Past And Present Encounters With Democracy' in L. Diamond, J. Linz & S. Lipset (eds.), *Democracy In Developing Countries: Asia*, Lynne Rienner Publishers, Colorado, 1989, pp. 442-43.

⁹ B. Anderson, *Imagined Communities: Reflections on the Origins and Spread of Nationalism*, Verso, London, 1983. On the idea of the importance for a state to cultivate loyalty through the promotion of material attachment see S. Mennell, 'The Formation of We-Images: A Process Theory' in C. Calhoun (ed.) *Social Theory and the Politics of Identity*, Blackwell, Oxford, 1994, pp. 175-97.

the benefits that it generated, and so access to the patronage network dispensed by the regime was often intense. Even so, competition between the local elites was deftly managed so that their loyalty to the central state was enhanced. This loyalty translated into an incentive to distance themselves from providing for the well-being of those local communities for which they had traditionally been responsible. Rather, their job was to assist with economic growth and, in so doing, their own economic and social rewards were tangible. This is an important point to which I will return later. The regime argued that such a strategy was not only necessary to fulfill their personal aspirations of economic wealth and political ambition, but was also essential for the security of the Republic.

In this way, the relatively swift turn around in economic conditions in the years after the New Order's ascendancy quickly established the new regime's authority. Unfortunately, by relying on economic progress as a measure of political legitimacy the New Order government was ultimately undone when the on-set of the Asian financial crisis in 1997 robbed it of the ability to purchase support via fiscal growth. Consequently, loyalty to the regime rapidly eroded. Old social and communal schisms percolated to the surface of Indonesian society while religious conflicts spread across the country. Amidst increasingly violent street demonstrations, Soeharto announced his resignation in May 1998.

Many of the methods used by both Sukarno and the New Order to centralise the country have since hampered the recent shift to a decentralised political and economic system. For this reason I now turn to the way in which these new regional autonomy laws were introduced and examine the impact of remnant nepotism on Indonesia's process of decentralisation.

Decentralisation

To ensure some level of stability during the period immediately following the resignation of President Soeharto in May 1998 it was necessary to respond to popular demands for change. Primarily this was to maintain a degree of order, particularly in areas such as Aceh, Sulawesi and East Timor where separatist tendencies were likely to use the period of political volatility to revive calls for independence or greater autonomy.

As Soeharto's chosen successor and former Minister for Technology and Science, President Habibie needed to quickly generate and then harness popular and political support to ensure that the reforms had credibility within an unstable and complex political environment.

Initial steps toward this end included policies designed to distance the administration from the New Order. On the diplomatic front Habibie moved to put an end to the East Timor crisis by outlining his willingness to hold a UN-supervised vote to measure whether East Timorese wanted to remain a part of Indonesia or to be granted their independence. However, this plan unravelled when conservative elements within the military conspired with pro-Jakarta militias to make an example of anybody with the audacity to support independence. The brutal and tragic consequences have been well-documented elsewhere.¹⁰ At the domestic level, especially with respect to growing restiveness in the provinces, the Habibie administration outlined a legislative program designed to appease disgruntled peripheral provinces and give the regions greater fiscal and administrative autonomy from Jakarta.

In principal, the essence of regional autonomy in Indonesia was to narrow the fiscal and political disparity between the provincial and central governments and, by so doing, to decentralise power, enhance democracy and to better the social welfare of regional communities. Two key autonomy laws were enacted during President Habibie's short tenure and together they established a framework for a more radically decentralised form of government: Law 22/1999 on Regional Government¹¹ and Law 25/1999 on Fiscal Balance between the Centre and the Regions.¹² Together this legislation ostensibly transferred significant power and revenue to 30 provinces and 365 districts (*kabupaten*) throughout the archipelago.¹³

¹⁰ See J. Nevins, *A Not-So-Distant Horror: Mass Violence in East Timor*, Cornell University Press, New York, 2005; R. Tanter, D. Ball & G. Van Klinken (eds.), *Masters of Terror: Indonesia's Military and Violence in East Timor*, Rowman and Littlefield, Lanham, 2005.

¹¹ Law No. 22, 1999 replaced both the Regional Government Law No. 5, 1974 and the Village Government Law No. 5, 1979.

¹² Law No. 25, 1999 empowered district and municipal governments to set resource use and manage both revenues and budgets.

¹³ C. Thorburn, 'The Plot Thickens: Decentralisation and land administration in Indonesia', *Asia Pacific Viewpoint*, vol. 45, no. 1, 2004, pp. 33-49.

The speed with which the government passed Laws 22/1999 and 25/1999 was underscored by the need for President Habibie to distance himself from his role in Soeharto's New Order government and his close personal relationship with the former President.¹⁴ In just over two years as President, Habibie passed nearly 60 new laws that responded to some of the many demands for political, economic and social reform. The implementation of the regional autonomy legislation was expected to unfold over four stages, arguably to ensure the continuity of public service delivery. In 2001, the first three policy areas to be devolved to a selected number of regions were administration, public welfare and public health. During 2002/2003 the remaining regions implemented these policies, while the period between 2004 and 2007 were to be marked by intensive consolidation. It was expected that the fourth and final stage, 2008 and onwards, would be used to amend gaps in the legal framework.¹⁵

This staged rollout has caused a number of domestic political and economic problems throughout the archipelago. The 'functional assignment' of obligatory and discretionary roles at different levels of government combined with mismatched funds to deliver such functions has caused considerable confusion both inside and outside the country.¹⁶ The consequences of this are evident in many key areas but most particularly in the management of natural resources. The mining industry is just one of a number of areas to suffer from this staged roll out of autonomy legislation and the next section examines why this is so.

Part 2: The impact of Indonesia's reforms

Regional autonomy and mining

¹⁴ It must be noted that this legislation was approved *before* the first post-Soeharto election and enabled district governments to regulate and govern the interests of the local people according to their own initiative. At the time former president, Lt. Gen. Susilo Bambang Yudhoyono was the newly appointed Minister of Mines and Energy.

¹⁵ A. Rabasa & P. Chalk, 'Reinventing Indonesia: The challenge of decentralisation' in A. Rabasa & P. Chalk (eds.), *Indonesia's Transformation and the Stability of Southeast Asia*, Rand Corporation, Jakarta, 2001, pp. 48-49.

¹⁶ On the issues of 'functional assignment' see G. Ferrazzi, *Assignment of Governmental Functions in Indonesia: Reforms and prospects*, Deutsche Gesellschaft für Technische Zusammenarbeit, Eschborn, 2007, p. 5.

Unfortunately, the mining sector¹⁷ is just one of several natural resource sectors, albeit the largest in terms of input to GDP, affected by the implementation and consequences of these new autonomy laws. The new autonomy legislation has had a significant impact on this sector due to the immobility of mining concessions and the nature of resource distribution: ores are more commonly found in just one district, in comparison to forestry and fishing resources which tend to be more widely distributed throughout a province.

Although Indonesia's mineral potential is ranked above Zimbabwe, South Africa, Bolivia and Chile,¹⁸ by the end of 1998, 34 (or nearly ninety per cent) of the 38 7th generation Contracts of Work¹⁹ (CoW) negotiated by the government with foreign companies were cancelled or postponed. In addition, by 2000 more than 170 exploration projects had been suspended²⁰ and it is estimated that exploration investment dropped from nearly US\$160 million in 1996 to less than US\$22 million in 2001.²¹ Some of this was due to the Southeast Asian monetary crisis in 1997 and the political instability following the resignation of President Soeharto in 1998. However, the impact of decentralisation on the mining industry cannot be underestimated.

This has been revealed in a recent study by the Fraser Institute (2008). The survey showed that mining companies are unwilling to start exploration in countries such as

¹⁷ 'Mining' usually refers only to ores such as gold, nickel and copper. Here it also includes coal although this resource is covered by separate legislation in Indonesia.

¹⁸ T. Wright & P. Barta, 'Indonesian Mining Stalls: Disputes over control halt development steps, pressure commodities', *The Wall Street Journal*, 7 February 2007.

¹⁹ The Contract of Work (CoW) system, which was developed incrementally over 30 years since its inception in 1967, established a relatively consistent and transparent method of acquiring mining rights for overseas companies. A CoW is a mining concession agreed between the company and the central government and grants exclusive mining rights over a defined geographical area for a 30-year term. The incremental changes to the CoW system are known as 'generations'. The most recently signed generation of contracts is the 7th although 8th generation contracts are also available. To date, no countries have signed an 8th generation contract. See G. Watkins, S. Kardono & A. Saraswati, 'Indonesia: Indonesian mining 2006' in R. McDermott (ed.), *Getting the Deal Through: Mining 2006*, Law Business Research Limited, London, 2006.

²⁰ Although this is indicative of the global drop in investment in mineral exploration during 1997/8 (due to a decrease in demand for metals), the sector was further impacted by the political and economic instability resulting from the financial crisis in Southeast Asia. See B. Bhasin & S. Venkataramany, 'FDI Law and Policy in Indonesia: Replacing the 'Contract of Work' system', Presented at the 10th International Conference of the Society for Global Business and Economic Development, Kyoto, August 8-11, 2007, p.3. See also World Bank, *Indonesia: Environment and Natural Resource Management in a Time of Transition*, World Bank, New York, 2001, p. 51. See also B. Bhasin & J McKay, 'Mining Law and Policy in Indonesia: Reforms of the contract of work model to promote foreign direct investment and sustainability', *Australian Mining and Petroleum Law Journal*, vol. 21, no. 1, pp. 79-85.

²¹ J. McBeth, 'Indonesia's Wasted Opportunity', *Far Eastern Economic Review*, 18 July 2002, p. 39.

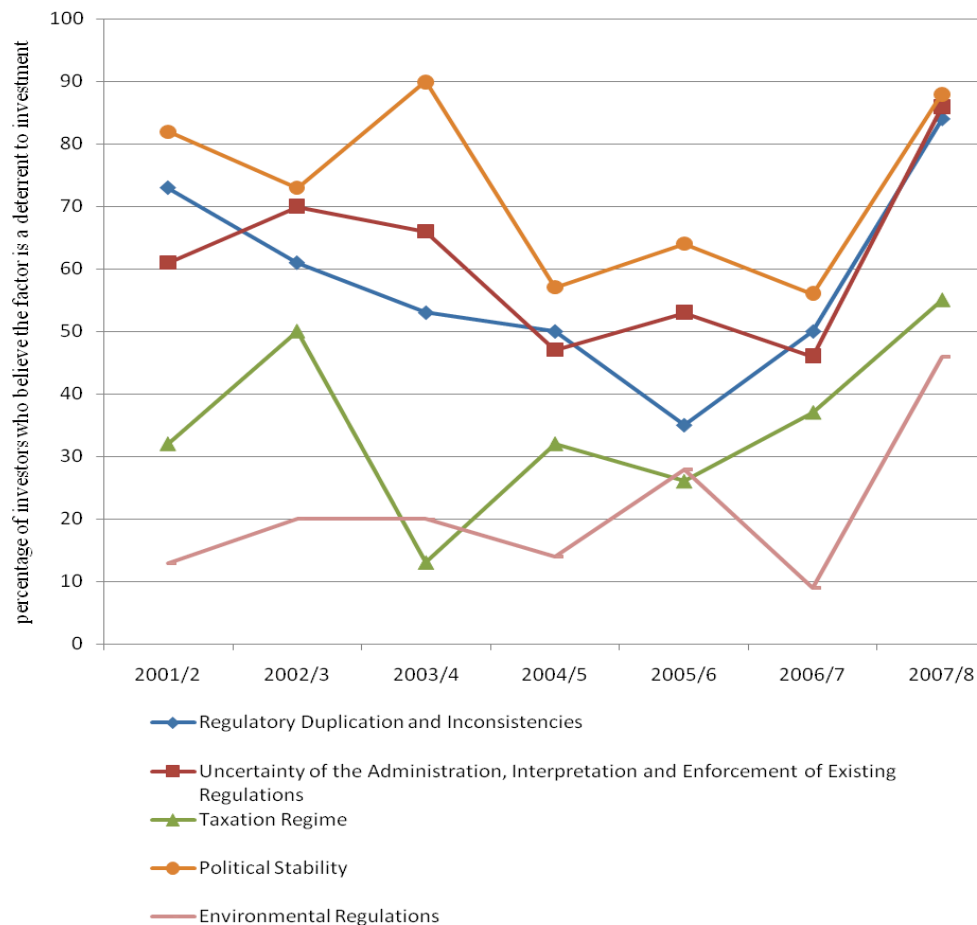
Indonesia where government policies impede investment despite the overwhelming amount of mineral potential. The latest 2007/2008 survey represents responses from 372 mining company executives and measures, among other indicators, the policy potential opinion index (PPI) which assesses the attractiveness of government policies from the viewpoint of an exploration manager. The index also notes the effects of increasingly onerous government regulations, uncertainty about land use, higher levels of taxation, and other policies that interfere with market conditions.

Each country is given an overall ‘score’ (with a maximum of 100) which reflects the extent to which cumulative conditions are likely to encourage companies to invest. In the previous report of 2006/2007 Indonesia scored just 23 out of 100 while Manitoba topped the 65 jurisdictions with a score of 93.1. Comparatively, Zimbabwe scored an unsurprising 2.9 (2.4 in 2005/6) and Chile 64 (in 2005/6 Chile scored 87: the large drop is attributed to political instability).²²

Impediments to investment in the Indonesian mining industry 2001 – 2008²³

²² F. McMahon & C. Vidler, *Survey of Mining Companies 2007/2008*, The Fraser Institute, Vancouver, 2008.

²³ The higher the number on the Y axis, the greater the percentage of investors who believe the factor is a deterrent to investment. This graph was produced by the author on the basis of data contained in the Fraser Institute’s annual ‘Survey of Mining Companies’, <http://www.fraserinstitute.org/researchandpublications/publications>, accessed online 8 July 2008.



Evident in the graph above is the high level of concern expressed by survey participants regarding some key political and economic problems now being faced by international mining companies in Indonesia. The graph shows that since the implementation of the new autonomy laws in 2001, political stability, ‘uncertainty of the administration, interpretation and enforcement of existing regulations’ and ‘regulatory duplication and inconsistencies’ have consistently been of the greatest concern to investors.

The graph reveals that foreign investors are also worried about a number of legislative inconsistencies between the central, provincial and district governments. There is also confusion over obligatory functions and minimum service standards which were insufficiently elaborated and not coherent under Law 22/1999. In turn, this has led to a lack of administrative competency at a district (*kabupaten*) level and an overlap of roles

between provincial and district governments. As is evident in the graph, investors are aware that these regulatory inconsistencies combined with uncertainty over the new regime's administrative capabilities do not promote a stable investment climate. Additionally, statistics from the Fraser Institute's surveys since 2001 show that, until recently, investment in the mining industry has fluctuated in line with political stability and will probably continue to do so until the gaps in the regional autonomy legislation have been rectified.

Finally, the new taxation regime specified in Law 25/1999 and uncertainty towards enforcement of existing regulations have both negatively impacted on investor perception. This has been compounded by the level of corruption at the district level. Both issues have been of great concern to investors and the next sections examine their impact on foreign investment in the mining industry

Political decentralisation and mining

The process of decentralisation chosen by the Republic's policy makers was in the form of regional autonomy. As opposed to deconcentration²⁴ or delegation to semi-autonomous organisations, the Habibie administration's initiatives focused on the decentralisation of power to regional areas through the process of devolution. In comparison to other processes of decentralisation, devolution "seeks to create or strengthen independent levels or units of government through devolution of functions and authority."²⁵ Devolution, or regional autonomy, is the most common method of political decentralisation in the developing world. This is because by creating new layers of government and relinquishing a degree of central control, there is an expectation that democracy will evolve more easily. Consequently, this system should allow for greater popular participation at the grassroots level due to their new-found proximity to the decision making process.

²⁴ Deconcentration is where central government responsibilities are transferred to the regions, although primarily in the form of administration. Until recently Indonesia operated with a deconcentrated government which allowed for the outward showing of some level of local input but in reality it maintained a centrally controlled system of decision making. See R. Seymour & S. Turner, 'Otonomi Daerah: Indonesia's decentralisation experiment', *New Zealand Journal of Asian Studies*, vol. 4, no. 2, 2002, p. 33.

²⁵ D. Rondinelli & G. Cheema, *Decentralisation and Development: Policy implementation in developing countries*, SAGE, California, 1983, p. 22.

In theory at least, such a decentralisation of power to regional governments should improve and promote sound and equitable development policy. This is primarily because of the closer proximity between decision-makers and those affected by their decisions. It is argued that this approach allows for increased opportunity for local public input and greater government accountability. However, in reality, while devolution does create autonomous local governments, it can also create significant duplication of power and bureaucratic activity and even in some circumstances lead to debilitating demarcation disagreements over who might have authority over a particular function in a particular area.²⁶ This has been the case in Indonesia where confusion over the implications of decentralisation has led to an array of administrative blockages across a wide range of areas. Much of this is the result of the manner by which the laws were designed.

The reasons for this are twofold. Firstly, the decentralisation agenda was developed under the leadership of former Soeharto ministers who were both materially and philosophically averse to federalism and more concerned with the maintenance of oligarchic structures and appeasing separatist tendencies.²⁷ As mentioned previously, it was these leaders who benefitted from Soeharto's policy of 'authoritarian corporatism' under the New Order government. Secondly, much of the decentralisation process was not preceded by badly needed administrative reforms at the regional level. In particular, local skills and capabilities were insufficient to manage many of the decentralised functions associated with stage one of the regional autonomy rollout. This has been particularly evident at the district level where initially at least thirty per cent were unable to implement the new legislation at the standard required by the central government.²⁸

According to a recent study conducted by the German government's international aid body GTZ (Deutsche Gesellschaft für Technische Zusammenarbeit), Law 22/1999,

[i]ntroduced some bold changes in 'who does what' in the context of sweeping decentralization and broader reforms. But this new decentralization

²⁶ H. Blair, 'Participation and Accountability at the Periphery: Democratic local governance in six countries', *World Development*, vol. 28, 2000, pp. 21-39.

²⁷ See I. Islam, 'Regional Decentralisation in Indonesia: Towards a social accord', *United Nations Support Facility for Indonesian Recovery*, Working Paper 99/01, 1999 and M. Sadli, *Establishing Regional Autonomy in Indonesia*, Paper presented at the University of Leiden, Holland, 15-16 May, 2000.

²⁸ The remaining 70% met only minimum standards such as having good administration management and useful local legislative assemblies that have the ability to accommodate public aspirations. Andi Mallarangeng [Head of Policy Commission at the Partnership for Governance Reform] quoted in 'Many Regencies not Ready for Autonomy', *Indonesia News*, 23 November 2000.

framework was hampered by shortcomings in the overall functional assignment architecture, in terms of structure and elaboration of components. Regional actors were also not sufficiently prepared to work with its bold new design, and tensions between levels of government quickly developed due to the misunderstandings and gaps in the framework.²⁹

This situation is a direct result of the manner in which decentralisation was devolved to both the provinces and *kabupaten*. Under the new autonomy legislation the political concessions granted under Law 22/1999 has been damaging on both a domestic and international level due to the confusion between discretionary and obligatory functions. Moreover, while Law 22/1999 stipulates that the ‘regional governments’ are responsible for eleven mandatory functions of public service such as health, education it does not sufficiently define the proper role of different levels of government.³⁰

For foreign investors there remains confusion over the roles and responsibilities of government and concern regarding the ongoing conflict as different levels of government and competing agencies stake their claims over vaguely defined roles and responsibilities. This is supported by a recent study by Regional Autonomy Watch that claimed that more than thirty per cent of 693 regional regulations showed a “lack of sensitivity with respect to the creation of a conducive business atmosphere.”³¹ At the regional level, what actually occurred in Indonesia was increased conflict between local villagers, NGOs and government entities. These stakeholders have used the period of political intransigence to make their own interpretation of the law and target mining companies for further demands of cash or ‘compensation’.³² This has resulted in many mining companies conceding to local demands for native land reparation during a period where both district and central governments are unwilling (or incapable) to play a key role in resolving disputes. For example, in 2002 South Sumatra and Bangka provinces had already issued their own mining laws. Bangka has included a new tax of US\$85 million simply to commence exploration while Newmont’s operation in North Sulawesi

²⁹ Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ) is an international cooperation enterprise for sustainable development. See www.gtz.de/en G. Ferrazzi, *Assignment of Governmental Functions in Indonesia*, p. 3.

³⁰ World Bank, *East Asia Decentralizes, Making Local Government Work*, World Bank, Washington DC, 2005, p. 246.

³¹ A. Rabasa & P. Chalk, ‘Reinventing Indonesia: The challenge of decentralisation’, p. 50.

³² B. Guerin, ‘Indonesia’s Mining Quagmire’, *Asian Times*, May 13 2003.

http://www.atimes.com/atimes/Southeast_Asia/EE13Ae01.html, accessed online 1 June 2008.

has been taxed for construction materials the company used to build a public road (at its own expense).³³

Despite this, in 2005/2006 there was some improvement in perceptions of political stability and uncertainty of the administration.³⁴ This is evident in the graph above and can be attributed to the implementation of two new laws on decentralisation in October 2004: Law 32/2004 which clarifies and adds to some of the obligatory and discretionary functions at each level of government as set out in Law 22/1999, and Law 33/2004 which clarifies how the functions given to regional governments in Law 32/2004 will be financed.³⁵ Additionally, during the 2005 elections for the first time governors (provincial leaders) and *bupati* (*kabupaten* leaders) were elected by the people. Some investors hoped that these changes would reduce corruption and improve transparency and accountability at a regional level by bringing the voters and government decision makers into a direct relationship. Unfortunately their hopes were largely unfulfilled and uncertainty about regional administration spiked again in 2006 (see graph above). This remnant of the nepotistic cronyism which played a significant role in Soeharto's patronage network has not only remained but has deleteriously affected the investment climate. This is particularly evident in the economic sphere as I discuss next.

Fiscal decentralisation and mining

Prior to decentralisation the country's fiscal imbalance had primarily been between Jakarta and the provinces. With the new autonomy laws in place the key disparity is now between the resource rich and the resource poor provinces. This is because of the new method of revenue distribution which was a key feature of Law 25/1999. Whereas previously the central government collected 90% of revenue and then reallocated a minor part of this to the provinces in the form of development funds and civil service salaries, resource rich regions are now benefiting as the legislation allocates 80% of natural resource revenue directly to the provinces. A 'special allocation fund' has been established for areas that are not resource rich but this does not prevent the

³³ J. McBeth, 'Indonesia's Wasted Opportunity', p. 40.

³⁴ Perceptions of governance generally lag behind institutional changes. See World Bank, *East Asia Decentralizes*, p. 244.

³⁵ See G. Ferrazzi, *Assignment of Governmental Functions in Indonesia*, 2007.

resentment between the regions as it cannot allocate enough taxes to compensate for the lack of resource richness or avert the formation of powerful coalitions between wealthy provinces. The latter have given rise to fears that such alliances may dominate the country's political sphere in the future.

The details of revenue sharing of natural resources under Law 25/1999 are worth closer inspection. Under the new regulations 80% of mining royalties will be allocated to the province in which the extraction occurs. From the 80% received, 32% is apportioned to the *kabupaten* where the mine is located, another 32% is divided equally and given to the other *kabupaten* within the province and the remaining 16% remains with the provincial authorities.³⁶ In addition to this, provinces now also receive taxes associated with water exploitation, 30% of any vehicle registration or vehicle ownership transfers tax, and 10% of taxes associated with fuel. The *kabupaten* fare more favourably than the provinces. They can now collect their own locally determined taxes on hotels, restaurants, entertainment, advertising, street lights, quarrying and parking.³⁷ Those districts that already have well established infrastructure will obviously benefit greatly from the new taxation scheme. Despite this, these amounts are small (approximately 6% of the net domestic revenue in 2003) and the more substantial taxes such as income, VAT, land and property tax remain under the control of the central government.³⁸

Moreover, many *bupatis* have used the vague legislation handed down from the central government to their benefit. By 2001 both the IMF and the World Bank had already expressed concern that *kabupaten* spending would double any previous expenditure at the same level. Some of this can be explained by a lack of fiscal planning experience at the local level but most, unfortunately, has been the result of exploitation and corruption. One *bupati* in the resource-rich region of East Kalimantan auctioned the forests within his constituency to a local mining company. Similarly, another *bupati* in East Java has sold a national park to local miners despite the presence of endangered

³⁶ On the Natural Resource Revenue Sharing Scheme see B. Resosudarmo (ed.), *The Politics and Economics of Indonesia's Natural Resources*, Institute of Southeast Asian Studies, Singapore, 2005.

³⁷ Law 32/2004 states that *kabupaten* government budgets must be sent to provincial governments for ratification. These new shifts in law suggest a return to the centralised regime of the pre-1999 era. H. Soesastro & R. Atje, 'Survey of Recent Developments', *Bulletin of Indonesian Economics Studies*, vol. 41, no. 1, 2005, pp. 5-34.

³⁸ B. Brodjonegoro, *The Indonesian Decentralization After Law Revision: Toward a better future?*, University of Indonesia, Jakarta, 2005, p. 5.

leopards within the area.³⁹ Elsewhere, local *bupati* are issuing illicit export licences to the local entrepreneurs. For example, the Indonesian mining company PT Tambang Timah, the world's largest tin producer, reported a 92% drop in profits.⁴⁰ This seems to have been a direct consequence of market saturation due to the proliferation of illegal mines extracting ore from Timah's concession. This would only be possible with the support of the local *bupati* to illicit mining, no doubt in return for financial reward. Jakarta's Trade Ministry representative in the area describes his position as, "an assistant to local officials – they are our bosses now."⁴¹

Independent sources support these stories of rampant corruption. A 2004 report published by Indonesian Corruption Watch revealed that 43 per cent of the corruption cases between January and December 2004 all occurred at the *kabupaten* level.⁴² This evidence has been supported by the World Bank's 2005 report on decentralisation throughout East Asia which concluded that 50 per cent of the firms sampled from Indonesia perceived decentralisation as having a negative impact on corruption at both district and central government levels.⁴³ In fact, the World Bank's Productivity and Investment Climate survey revealed that most businesses believed corruption to be worse at the district rather than national level.⁴⁴ Earlier this year (2008) the Indonesian Survey Institute similarly revealed that 40% of respondents rated conditions for investment worse or much worse than ten years ago.⁴⁵ Jaya has also noted that decentralisation has brought in its train increased corruption at the local provincial and district levels.⁴⁶

Much of this corruption occurs through the levy of new, sporadic taxes and duties. Regional Autonomy Watch suggests that the increase in locally determined taxes is

³⁹ D. Djalal, 'Jakarta to Pass the Buck: Investors fear if power corrupts, regional power corrupt absolutely', *Asian Business*, vol. 37, no. 2, 2001, p. 67.

⁴⁰ Matters became worse when in October 2001 world tin prices fell to a record low of US\$3600 a tonne (it costs US\$4000 to produce the same amount).

⁴¹ Ramlan Nuri quoted in D. Djalal, 'A Law Unto Themselves', *Far Eastern Economic Review*, 6 December 2001, p. 28.

⁴² Indonesian Corruption Watch, *Regional Autonomy, The Fertile Land of Corruption: Law and justice in Indonesia is still biased to the corruptors*, Indonesian Corruption Watch, Jakarta, 2005.

⁴³ World Bank, *East Asia Decentralizes*, 2005.

⁴⁴ World Bank, *Productivity and Investment Climate Survey*, World Bank, Washington DC, 2005.

⁴⁵ The 1200 respondents were from all levels of the population throughout the archipelago including Irian Jaya and Aceh. Lingkaran Survei Indonesia (Indonesian Survey Institute), 'Reformasi Setelah 10 Tahun' (Reform after 10 years), *Kajian Bulanan (Monthly Analysis)*, 13 May, accessed 18 June 2008 at <http://www.lsi.co.id/>

⁴⁶ W. Jaya, 'An Institutional Approach to Fiscal Decentralisation in Indonesia', 2008.

impairing the investment climate. Moreover, the organisation claims that most of the taxes imposed in recent times have been formulated with little consultation to either the central government or local residents.⁴⁷ Despite a requirement under Law 33/2004 for national authorities to review all regional legislation relating to taxation a recent study estimates that up to 60% of these regulations have not undergone the review process.⁴⁸

The combined evidence of inept and corrupt *bupatis* suggests that the Indonesian government must act swiftly to improve the investment climate for multinational mining ventures. The Ministry of Energy and Mineral Resources is moving in the right direction with the drafting of a new mining bill. The bill, currently being discussed by a parliamentary committee, would disestablish the current CoW system and ensure that mining legislation moves in alignment with the regional autonomy laws. However, as I argue below, this answer to Indonesia's natural resource management is not as simple as it may seem.

Part 3: Possible outcomes of Indonesia's reforms

Although any rights and obligations stated in current CoW are immune from subsequent legislative changes in law, royalties and tax rates, under the present conditions there remains considerable reluctance to invest in the mining industry. Consequently, current mining operations will continue but new ventures will not be undertaken. In the past the CoW system made Indonesia a particularly attractive country in which to invest as it guaranteed security of tenure, allowed for greater flexibility and had competitive and stable royalty rates, particularly in comparison to neighbouring countries.⁴⁹ However, under the proposed new tax scheme any future contracts will be subject to a higher level of taxation. Potential tax burdens (or royalties) will increase from 2% to an average of 4% making Indonesia's mining industry uncompetitive with

⁴⁷ Regional Autonomy Watch, *Regional Investment Attractiveness: A survey of business perception*, Asia Foundation, Jakarta, 2004.

⁴⁸ B. Lewis, 'Tax and Charge Creation by Regional Governments under Fiscal Decentralization: Estimates and Explanations', *Bulletin of Indonesian Economic Studies*, vol. 39, no. 2, 2003.

⁴⁹ B. Wahju, 'Indonesian Mining Industry in the Period of Transition, Between 1997-2001', *International Convention, Trade Show Investors Exchange*, Indonesian Mining Association, Toronto, 2002, p. 16.

other mineral producing countries where taxes are significantly lower.⁵⁰ In a country where the rate of return is already lower than in other mineral producing countries, competition will further decrease investment if the proposed taxation changes proceed.⁵¹ Moreover, as these companies move to more attractive rival countries Indonesia will lose an important source of human capital and expertise including geologists, drillers and surveyors.⁵²

Multinational companies will remain reluctant to invest under these conditions. In fact, there is already evidence that mining ventures have been stymied by the decentralisation process. No new CoWs have been issued to foreign investors since the autonomy legislation was adopted. Such industry apprehension is evident in the publication of an industry report in March 2007. The statement, issued by major mining companies operating in Indonesia, calls on the Indonesian government to retain the CoW system if it wants to avoid creating a major impediment to new investment. Instead, the Energy Ministry is moving forward with the draft mining bill.⁵³

The proposed mining bill

The proposed bill will update the 1967 mining legislation in a number of ways. Primarily the bill will provide a greater level of environmental protection, require better reporting of data and operations, improve land compensation provisions and incorporate greater recognition of local community rights. Should the bill pass, in future a mining firm will operate with a license issued by the district authority in the area where the mine is located rather than by the central government. Moreover, unlike the CoW system, where disputes are settled through independent arbitration, under the new licensing system all arbitration will be managed by the district authorities.⁵⁴

⁵⁰ World Bank, *Indonesia: Ideas for the Future*, World Bank, New York, 2005, p. 3.

⁵¹ Australia's rate of return is 18% whereas Indonesia's is 11.2%. J. McBeth, 'Indonesia's Wasted Opportunity', p. 39.

⁵² S. Dhume, 'Poor Prospects for Digging', *Far Eastern Economic Review*, 8 February 2001, p. 24.

⁵³ I. Krisnamantari, 'Miners Issue 'White Paper' Against Draft Mining Law', *Jakarta Post*, 21 March 2007.

⁵⁴ World Bank, 'Indonesia: Environment and Natural Resource Management in a Time of Transition', p. 51. See also B. Balbir & V. Sivakumar, *Mining Law and Policy: Replacing the 'Contract of Work' System in Indonesia*, Presented at 10th International Conference of the Society for Global Business and Economic Development, Kyoto, August 2007, pp. 4-5.

Most importantly, the new mining bill seeks to minimize some of the obstacles faced by mining investors in Indonesia by both reducing the uncertainties which have arisen from the implementation of the new regional autonomy laws and eliminating the contradictions of overlapping laws. However, one of the key problems with the new mining bill (and indeed the entire process of decentralisation in Indonesia) has been the lack of consultation with stakeholders. Hence the bill is built on premises that may not address the concerns of foreign companies wishing to explore and invest in the Indonesian mining industry. It is likely that the 414 provisions in the draft bill will not be sufficient to reassure foreign mining companies if it allows inexperienced district officials to continue to regulate the industry. Moreover, critics argue that the bill is loosely worded and will decrease the power of multinational mining companies seeking legal recourse against local claims for further compensation.⁵⁵

Despite these concerns, ongoing delays in passing the bill mean that Indonesia is currently losing a key source of income as companies wait to see what the new regulations will require. In 2007, Rio Tinto expressed interest in building a US\$1 billion nickel mine in Sulawesi. During a period where nickel reached record prices postponing development of the mine while regulatory problems are resolved is now delaying a badly needed financial boost to the country's economy.⁵⁶ Exploration budgets have been radically decreased as companies move to other resource rich countries which have more stable economic and political environments that guarantee a higher return on investment. Whether and how this might change in Indonesia's favour as a result of the current global financial crisis is something that cannot be predicted. So for the moment, the long term trend in investment in Indonesia's mining industry by foreign firms is likely to continue downwards.

Conclusion

Although Indonesia's mining legislation is still undergoing final review by the Constitutional Court, Priyo Abadi Soemarno, Executive Director of the Indonesia Mining

⁵⁵ T. Wright and P. Barta, 'Indonesian Mining Stalls: Disputes over control halt development steps, pressure commodities', *Wall Street Journal*, 7 February 2007, p. 9.

⁵⁶ T. Wright and P. Barta, 'Indonesian Mining Stalls', p. 8.

Association, is confident that the new mining law once passed will attract greater interest in the mining sector. However, it remains to be seen if his optimism is justified. Will the proposed mining legislation impede or increase the likelihood of foreign investment in the mining sector? What impact, if any, will this have on problems currently being experienced throughout the archipelago due to the implementation of regional autonomy? Moreover, there is now the additional burden of the global financial crisis that began in September 2008 which is likely to put extra pressure on developing countries.

Despite these negative factors, uncertainty over the distribution of executive power has been improved by the ratification of associated legislation to overcome a number of key issues which were not specified under the very general legislation passed in 1999. Earlier this year (2008) the Indonesian Government issued a stop-gap regulation (Law 2/2008 on Non-Tax State Revenues) to allow utilisation of forest areas for development purposes other than forestry. This has facilitated the issue of licenses to 14 domestic mining companies to pursue extraction activities over a total of 11.4 million hectares of previously protected forests. Such a move has momentarily stabilised domestic interest in the sector but fails to improve conditions adequately for foreign investors. At the same time, the environmental impact of this new domestic mining is not a happy prospect; there is also the potential threat to possible tourism.

It is now evident that large and high-grade levels of mineral deposit alone are no longer sufficient to attract foreign investment in the mining industry. Moreover, district licensing rules need to be consistent, predictable and stable for the duration of the contract. National standards should address issues such as criteria for granting contracts, land access agreements and compensation and reporting requirements.⁵⁷

Most importantly, any new regulations should ensure that registration of mining rights is consistent across the nation and defines the central government's oversight role to ensure adequate mine safety and environmental standards. Beyond this, however, we can expect that so long as district governments assume responsibility for regulating mining, provincial mining management will remain diverse, resulting in varying degrees of attractiveness to potential investors. Inter-provincial competition for mining investment is, therefore, likely to increase. There is a widely held view that the new

⁵⁷ World Bank, 'Attracting New Mining Investment', p. 3.

mining bill is a necessity for both the management of Indonesia's natural resources and the knock-on benefits for the economy. However, the final proof of the new law's effectiveness will be whether it attracts new and greater levels of mining investment in the future and whether that investment promotes Indonesian development more generally.⁵⁸

⁵⁸ 'Indonesia's Draft Mining Law, <http://www.usembassyjakarta.org/econ/mininglaw2001.html>, accessed online 6 June 2008.