Indonesia’s Mining Malaise and Deeper Challenges to Growth
By James Castle

Recent changes imposed on the mining industry in Indonesia, including a ban on the export of unprocessed ore, have shaken foreign investors and made the country a very tough place for the extractive sector. The roots of this resource nationalism go much deeper than mining, writes James Castle, and reflect the ambivalence of many Indonesians toward foreign investment in the private sector more generally.

“742 mineral exploration and development companies surveyed by Vancouver’s Fraser Institute say Indonesia is the worst place to do business out of 96 global jurisdictions” — Mineweb, Mar. 1, 2013.

THE DECEMBER 5 REFUSAL by a committee of the Indonesian legislature to extend a deadline for banning the export of unprocessed mineral ore is only the latest regulatory blow to the country’s beleaguered mining sector.

Well before this latest setback, the Fraser Institute’s highly regarded global survey of mining conditions rated Indonesia’s regulatory climate dead last in terms of its investment attractiveness. Is Indonesia’s 2009 Mining Law and the domestic smelting requirement that grew out of it primarily responsible for this rating? Should this be viewed as simply a case of resource nationalism gone wild or does it reflect more fundamental Indonesian attitudes toward foreign direct investment in particular and the private sector in general?

There is no doubt that exploration investment in mining has stagnated badly in democratic Indonesia and that the 2009 law offers extremely unattractive terms and conditions to potential investors. In the 1980s and 90s, the country consistently attracted 3-5 percent of the global exploration dollar. Today that is less than 0.5 percent. This decline is not due to a lack of attractive geology with great mineral potential. Fraser’s annual survey has also consistently rated Indonesia as among the best potential areas for mining investment. In the latest survey that named Indonesia the worst place to do business for miners, it was ranked fourth for potential out of 96 sites studied, trailing only Mongolia, Canada’s Yukon and Papua New Guinea. Neither ranking comes as a surprise to those who follow the sector here.

JUST MINING OR SOMETHING MORE?
While the terms and conditions of the 2009 law are very unattractive to potential investors, it does cover all miners, not just foreign investors. But the attempt to eliminate the long-established Contract of Work (CoW) regulatory structure and ban the export of unprocessed ore falls most heavily on foreign investors, who dominate the sector. Thus it is important to understand whether the current turmoil is simply a case of resource nationalism or a temporary fit of jealousy over large profits made by miners in the commodity boom that characterized much of the first decade of this century, or a trend that reflects broader attitudes toward foreign investment.

It is certainly difficult to generalize about the complex patchwork of emotions and attitudes that have informed Indonesia’s economic thinking and legislation over the past decade, but deeper trends beyond resource nationalism are at work and a little background is helpful in understanding what they might be.

LOOKING BACK
A long flirtation with communism and socialism after Indonesia won its independence in the 1940s led to the nationalization of virtually all foreign investment in the late 1950s and early 1960s and the creation of a dominant, inefficient state-owned enterprise (SOE) system of development. A new, anti-communist, authoritarian government calling itself the “New Order” reopened the country to international investment in the late 1960s, but it never abandoned its heavy reliance on state-owned companies and direct government intervention in most areas of the economy.

Nevertheless, starved for capital and eager to attract investors who were willing and able to find and unlock what would prove to be a vast hoard of mineral and hydrocarbon resources, the new government quickly established a bold new legal structure — the CoW — that has attracted tens of billions of dollars of investment and produced billions in revenue for the country. The CoW essentially granted exploration and development rights for extended periods to intrepid explorers who were willing to take a risk in a country with a recent history of left-wing government and expropriation of foreign investment properties.

Foreign companies quickly came to dominate the resource sector as they were the only ones with the capital, technology, patience and risk appetite for the daunting task. State-owned miners were a distant second, and local private companies initially played virtually no role. The few domestic entrepreneurs who could possibly have mobilized capital in that era had neither the technology nor the patience for mining. And, as today, there were many other opportunities for local investors in fast-growing Indonesia that provided higher returns in shorter periods with much less risk.

It is also important to bear in mind that Indonesia has never recognized private property rights related to natural resources. Under its constitu-
tion, all natural resources belong to the central government, which has the exclusive right to manage their exploitation. Although there has frequently been tension between the central and local governments over the right to manage local mineral resources, no significant political force in Indonesia has ever questioned this constitutional provision.

There has never been any question, then, of foreign or even private domestic ownership of mineral resources. A CoW was simply a contractual agreement whereby a mining company was contracted for a specific period, often 20 or 30 years, to explore and, if successful, develop a resource on behalf of the government.

Absent private ownership or property rights, the CoW mechanism proved to be a very efficient way to allocate limited resources. Indonesia benefitted greatly from jobs, royalties, taxes and infrastructure development. Successful private investors also made reasonable returns.

So although there is no foreign ownership, foreign investors have been a dominant force in Indonesian mining over the 40 years that the CoW structure has been in place. Not surprisingly, the importance of foreign capital in such a strategic and profitable sector has also prompted significant bouts of unease in elite circles.

The reasons for this unease are many and complex, but chief are: a belief that at a time of economic weakness Indonesia granted terms that were much too generous to foreigners; worry and resentment about dependency on foreign capital; environmental concerns; tensions between the central government and local populations; legal constraints that CoWs place on government intervention; and the desire of individual members of the elite to gain a greater piece of the action.

As a result of these concerns, CoWs have gone through a number of modifications, usually improving the government’s position at the expense of the investor. The changes generally shortened the contract period and/or mandated that a certain percentage of equity be sold to local interests within a defined period of time, often culminating in a requirement for majority domestic ownership after 20 or 30 years of operation.

Because of the strong control of the central government in the authoritarian period under former President Suharto, and its recognition that Indonesia’s limited capital and technological skills could be better used elsewhere, the basic structure of the CoW was preserved and defended by the regime.

The only serious concession to local interests was to control the divestment process and ensure that only privileged buyers (acceptable to the government) had the opportunity to purchase divested shares. The share purchase was usually totally financed by the seller, making it an extremely lucrative, risk-free transaction for the buyer. Needless to say, this fueled further resentment among Indonesians frozen out of the process by New Order cronies.

NEW GOVERNMENT, NEW RULES
When the Suharto regime fell in 1998 amid the economic chaos of the Asian Financial Crisis, democracy came to Indonesia and change was demanded. Many supporters of reformasi — as the pro-democracy movement of the late 1990s came to be called — never held the private sector in high regard. And the cronyism that characterized the divestment of mining resources under Suharto further undermined the legitimacy of the private sector in the eyes of many who were to take power in the democratic era. When democracy came, they argued passionately for greater government control over the private sector in general and the resource sector in particular. Democratic Indonesia has consistently demanded a greater share of the mining action.

The two consistent themes of economic development in democratic Indonesia have been the expansion of the state-owned sector and the narrowing of the space for foreign investors through restricting investment in many non-strategic sectors and an intensification of divestment requirements. The government increasingly sees the private sector as a tool of public policy, rather than economic development. Indonesia’s first democratically elected legislature in over 40 years took office in 1999 and quickly announced that it would produce a new mining law. This proved to be a difficult task that was to absorb the energies of three presidents and two successive legislatures for a full decade before it was passed in March 2009.

While Indonesia was certainly not the only country where record high commodity prices attracted the attention of significant domestic political and business interests and increased jealousy toward the profits being made by foreign investors, perhaps it was unfortunate that this legislative review took place at a time when many commodities, including gold and copper, hit all-time highs.

THE UNIQUE ROLE OF COAL
During this boom period, coal became an important and valuable commodity for the first time...
in Indonesian history. Coal mining is very different from most hard rock mining. Compared with copper or gold mining, coal mining is a relatively cheap and low-tech overburden removal operation that scrapes coal into trucks or onto barges and then ships it to market with very little processing required.

Unlike in the 20th century, many Indonesian companies now had the capital to invest, and coal mining quickly became a local game, with foreign involvement generally limited to financing and off-take arrangements or, at most, minority equity positions. Unlike gold, copper and nickel operations, mining technology also was readily available to rent from foreign and, increasingly, domestic engineering and construction companies.

As a result, local operators with limited technical knowledge and without significant foreign investment have made huge fortunes in coal over the last decade. This success has in turn convinced policy-makers, local government officials and wealthy local entrepreneurs that foreigners were not really needed in other mining sectors.

The coal sector phenomena, high commodity prices, local success and a limited role for foreign investors had a powerful influence on the new mining industry. There is simply a strongly held belief that Indonesia and Indonesians are being badly disadvantaged by the current structure of the coal sector. Unlike gold, copper and nickel operations, mining quickly became a local game, with foreign exploration and exploitation rights were separated, and an explorer who found a deposit was no longer automatically entitled to rent from foreign and, increasingly, domestic engineering and construction companies.

The economics of the regulations that have brought us to the current impasse — limited exploration, constrained investment and the prospect of a prohibition on exports — are so poor, the structure of the regulations creating this situation so haphazard and the contempt toward private investment principles so obvious, that the actions of so many otherwise rational actors in the legislature and the government can only be explained by recognizing the deep emotional dissatisfaction with the current structure of the industry. There is simply a strongly held belief that Indonesia and Indonesians are being badly disadvantaged by the current structure of the industry and that foreigners are benefiting disproportionately and perhaps unfairly.

Many feel that the minerals will always be in the ground and will always have value; therefore, it is better to wait until Indonesians can mine them themselves and keep all the benefit in the country. Why should foreigners benefit from Indonesia’s riches?

But this attitude is also spilling over into other sectors and is currently reflected in the difficulty the government has had in producing long-awaited revisions to its infamous Negative Investment List (DNI) that restricts foreign investment in many sectors. The government has promised to be more accommodating but for months has been unable to agree on adding any changes that offer more opportunities to foreigners.

DEEPER ISSUES

It would be comforting to proponents of an open economy and the value of foreign investment to believe that the profound discomfort currently being expressed toward foreign mining companies is limited to the resource sector. Indeed, no industry seems to attract the strong emotional resistance to foreign participation among significant segments of the Indonesian elite as natural resource exploitation.

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NO DEBATE

There are those who hold a contrary view and see the development of natural resources as an urgent way to create the capital and pay the taxes the country needs to reduce the poverty of much of its population and propel Indonesia into the global economic elite. They also see an open economy and attracting substantial amounts of foreign capital as the only way to survive, let alone thrive, in a global market that is becoming more challenging, competitive and competitive every day. At present, however, this latter group has been cowed into silence by the perception that domestic political success depends on espousing greater state control and an almost autarkic restriction of the role of foreigners and foreign capital in the country.

The key lesson that can be gleaned from the malaise that has afflicted mining in Indonesia for the past 15 years is that the role of foreign investment in the economy — and, by extension, Indonesia’s participation in the global economy — is being challenged by potent political forces with a strength and an energy not seen since the early 1960s. The lack of serious public discussion of this dramatic change in direction is the most worrying feature of this entire drama.

Democratic Indonesia has not yet developed the public institutions needed to debate and resolve contradictory aspirations. As a result the country has been left with an economic policy framework that claims it wants to attract more investment at a time when it is insisting on divestment. Policy-makers say they want to modernize the manufacturing sector to create a globally competitive economy while at the same time protecting the many poorly capitalized, low-tech, uncompetitive manufacturers that now populate the sector. They say they want to accelerate the transfer of technology and create knowledge-based industries while at the same time reducing work permits for foreign technicians and restricting private investment in education.

The mining malaise is only the most prominent manifestation of a dangerous and contradictory confusion in which there is a desire to be independent and prosperous while at the same time being isolated from external challenges and protected from economic restructuring. If the current trend prevails, the economy will stagnate and Indonesia will be left on the sidelines as Asia re-asserts its role as the center of the world economy.