

Rational Choice Theory in the Scheme of Mining Shares Divestment Based on National Interest Protection

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This paper is a revised version and an expanded version of the paper entitled 'Shares Divestment Scheme in Indonesian Mining Law'. Several cases of ICSID are cases of shares divestment, one of them is the Freeport case that offers divestment by giving the assumption of investment if the Government extends the Freeport Operational License until 2041. It violates determination of divestment share price as the value should be based on fair market price without calculating the amount of minerals. Shares divestment execution is often hampered by the determination of divestment shares' price. The purpose of the divestment arrangement was not achieved because of the price fixing issue which causes divestment failure or causes divestment delay, and the shares that were previously for the government eventually fell on private shareholders which might be owned by foreign parties. This paper is a legal research. It is intended to formulate a shares divestment scheme in the mining sector in Indonesia based on rational choice theory and public choice theory, which is expected to give a valuable contribution to the Government of the Republic of Indonesia as well as stakeholders and can be the ontological basis for laws and policies related to the investment and mining laws in Indonesia. The approaches which are used are the conceptual, statute, case and comparative approach. The primary legal materials that are used are legislation, international conventions and court decisions, while the secondary legal materials are in the form of literature and related materials.

Key words: *Investment law, mining law, national interest, rational choice theory, shares divestment.*



Introduction

This paper is a revised version and an expanded version of the paper entitled 'Shares Divestment Scheme in Indonesian Mining Law', presented at the International Law Conference 2018 (i-NLAC2018), Kuala Lumpur, Malaysia, 4th - 5th September 2018. This research is conducted based on the idea of the importance of finding a shares divestment scheme over foreign direct investment in the mining sector based on rational choice theory and public choice theory.

With the existence of Article 33 (2) and (3) of The 1945 Constitution of the Republic of Indonesia, related to the state control over natural resources, the Government of Indonesia issued policies stating that all of the foreign mining companies in Indonesia, both contract of work (KK) and Mining Business License (IUP) and Special Mining Business Licenses (IUPK), are subject to Law Number 4 Year 2009 (Law 4/2009) regarding Mineral and Coal Mining and to conduct shares divestment to the investor which should be done within the period of 5 years of the production. This is conducted gradually by the Government, Provincial Government, Municipal or Regencies Government, State Owned Company (BUMN), Regionally Owned Company (BUMD) or private companies. If the Central Government is not interested in buying the shares, the shares divestment must be conducted through an Initial Public Offering (IPO).

The execution of share divestment policies in reality is not going well. This can be seen from several cases of Indonesia in the International Centre for the Settlement of Investment Dispute (ICSID), related to the share divestment cases. One of these cases is the Freeport divestment case (2016).

In the beginning of January 2016, Freeport offered a 10.64% share to be divested, which is equal to USD 1.7 billion, meanwhile the government negotiate for less than half the value, to USD 630 million (CNBC Indonesia, 2018). The divestment share value which is offered by Freeport also includes the assumption about the investment, which may be invested by Freeport if the government extends the operational license of Freeport until 2041. If it is referred to the working contract of Freeport it will be ended at 2021, but the Government has not agreed upon the extension of the Freeport contract. It means that the copper and gold resources will be fully owned by Indonesia by the end of the contract in 2021.

Ministry of Energy and Mineral Resources Decree Number 9 Year 2017 also states that divestment share pricing should be based on fair market value without calculating mineral and coal reserves which is owned by the state. Thus the share pricing which is including the



following investment value which is conducted by Freeport is not in line with fair market value principles since it should not be determined by including the reserves of natural resources. On September 2017 Freeport sent a letter to the Government of the Republic of Indonesia about the refusal to conduct 51% shares divestment, thus on November 2017 the Government formed Holding Mining State Owned Company in order to prepare the divestment share purchase by a corporation.

Share pricing is the most important matter in shares divestment. Shares divestment execution is often hampered by the determination of divestment shares' price. The purpose of the divestment arrangement was not achieved because of the price fixing issue which causes divestment failure or causes divestment delay, and the shares that were previously for the government eventually fell on private shareholders which might be owned by foreign parties. To fix these problems, there should be a review into the national interest protection over divestment policy in the sector of mining and coal, based on the principles of state control over natural resources which is intended to fulfil the state objectives. Referring to those backgrounds, the legal issues which will be explained in this journal consist of shares divestment scheme in the sector or mining and coal based on rational choice theory and public choice theory.

Methods

This paper is a legal research. It is intended to formulate a shares divestment scheme in the mining sector in Indonesia based on rational choice theory and public choice theory, which is expected to give a valuable contribution to the Government of the Republic of Indonesia as well as stakeholders and can be the ontological basis for laws and policies made related to the investment and mining laws in Indonesia. The approaches which are used are the conceptual approach, the statute approach, the case approach, the comparative approach, and the economic analysis of law. The primary legal materials which are used are all applicable legislations, international conventions and court decisions, while the secondary legal materials are in the form of literature and related materials.

Result and Discussion

Divestment scheme for the scope of mining is the essential problem in the economy. The domination of the mining industry by foreign companies tends to leave behind the welfare of the people, which is the main purpose of our state. As a result, people only bear the environmental loss which is caused by mining activity, compared to the benefit which is obtained from mining activities. For instance, in the gas and oil mining sectors, the



environmental loss cost, which is caused by mining activities, should be followed by compensation which should be paid by the company (mitigation program) (The World Bank, Year, p. 6).

The peoples' contribution, which is relatively low in the mining activities, causes conflict which is one of the risks for mining company. The relation between mining activities and environmental damages, sustainability and social justice has the potential to cause conflicts of interest. On its development, generally divestment cases cannot be solved yet. This shows that there is problem in the divestment scheme which only focuses on monetary issues from the foreign investment side and it has not covered peoples prosperity, sustainable development or environment eco social justice which should be achieve in order to obtain national energy security.

In deciding policies related to the state's political economic condition, this can be conducted by using two kind of approach; Public Choice Theory and Rational Choice Theory. These theories are created because political and economy regimes are contrary to each other in the policy making process.

A. *Public Choice Theory*

Public Choice Theory (PCT) is the use of economics to understand political science (D. Daniel Sokol, 2011, p. 1029). PCT incorporates into economic models for the behaviour of political agents, such as voters and politicians, whom traditional economists treated as external factors (Guido Pincione, 2004, p. 451). PCT is defined as a science to analyse political science by economics framework, followed up with its application into legal science. PCT applies an economic approach to the relevant politic institutions before it is used to analyse law doctrines (Maxwell L. Stearns and Todd J. Zywicki, 2009, p. 1-2). PCT is used for analyzing government and political behaviour based on models of individual choice (Daniel A. Farber, 2014, p. 1).

In PCT, one of the political agents who plays an important role are legislators as political agents, who are assumed as rational agents who are have the potential to be self-interested by maximizing their own benefits or utilities depending on the resources. The concept of rationality underlying PCT is instrumentalist: actions are chosen because of their capacity to produce desired outcomes, not because of ethical precepts relating to the intrinsic nature of the action (Daniel A. Farber, 2014, p.2). Instrumental rationality makes room for the sort of rules that lawyer and judges must presuppose when they interpret legal rules (Guido Pincione, 2004, p. 453).



PCT uses collective behaviour (Shepsle, 2010, p. 355) or collective actions for decision making by applying certain insights derived from the study of private economic behaviour to collective action problems (Paul B. Stephan III, 1995, p. 746). There are three elements of decision making strategy in PCT, they are: the use of simplified models to describe collective behaviour, decomposition of collective behaviour into individual behaviour, and analysis of individual behaviour based on instrumental rationality (Daniel A. Farber, 2014, p.2). The goal of these strategies is to get strict and realistic comprehension about decision making in government institutions.

There are two main elements to represent PCT, which are Rent-Seeking Behaviours and Interest Groups. Interest Groups are an organized group, outside the decision-maker in politics, who brings up and fights for their interests (Gordon Tullock, 2005, p.9). Rent-Seeking Behaviour is an action done, by a benefit-oriented party, for certain benefits by convincing decision makers. When Rent-Seeking is done, there will be a free ride group which is used by certain groups, derived from the policy making strived made by the Interest Group (D. Daniel Sokol, 2009, p. 1034).

The implementation of PCT, in the decision making process, leads to a voting paradox as the worst possibility in the decision making process. A voting paradox a condition where the voting process tends to be opened, which will likely cause problems in hierarchy preference that can lead to a failure of the decision making process, in majority votes or in absolute position. The decision making process which is conducted by the House of Representatives (DPR RI) as a legislator, use deliberation principles in order to achieve a consensus. However if a consensus cannot be reached, the DPR RI decides it based on majority votes. The regulation related to the decision making procedures is one of the measure to prevent a voting paradox in the decision making process which is conducted by the DPR RI. However, a voting paradox can still happen when decision making comes to a deadlocked position (Pramudia A. Oktavinanda, p. 10-13). A voting paradox shows that the democratic system still has inherent gap which can be used by certain parties to fulfil their own interest. This condition promotes Rent-Seeking Behaviour from Interest Groups (Garfield, 2018).

The application of PCT in decision making creates two choices. First, the decision made by the government will benefit the society by not changing the laws and regulations with the condition that the benefits and costs arise from the policy which will be equally widely distributed to the society. Second, the decision will only benefit Interest Groups by changing laws and regulations with the condition that the benefits of the policy will only be distributed

to the Interest Groups, but the costs arise by the issuing of such a policy which will be widely distributed to the society.

In the perspective of share divestment in the Freeport case, there are 2 possibilities for the Government to decide policy over it, based on Public Choice Theory, they are: (1) Not changing the divestment policy, which is made for the sake of peoples' interest, but determine the divestment share price clearly or (2) changing the divestment policy in order to accommodate Freeport interest. Both choices will create a voting paradox, therefore Freeport as an Interest Group will be engaging in Rent-Seeking Behaviour to cut the preference cycle. If this action succeeds, the probability is that the government would choose the second choice to be implemented. It can be concluded that from these options, the implementation of PCT on share divestment policy is intended to make decisions which will bring more benefit for people by not changing the divestment scheme policy. However, the government needs to determine the divestment share price, thus the benefit or utility of the policy will be well distributed to the people.

From an economic perspective, mines are not included in public goods. Economists cite national security, a deliberative political and legal culture, and clean air and highways as examples of nonexclusive and free goods (Paul B. Stephan III, 1995, p. 749). Public goods cannot easily be converted into property interests. The production of public goods is subject to a generalized prisoner's dilemma: each potential consumer ends up worse off vis-a-vis a situation in which greater amounts of public goods are produced at every consumer's expense. (Guido Pincione, 2004, p.457). Although mines are not included to be public goods, the mining sector is still provided by the state under the constitution, Article 33 of The 1945 Constitution of the Republic of Indonesia. Therefore, the existence of free riders and rent seeking behaviour can still possibly happen.

B. Rational Choice Theory

The low development of the economy, technology, and income per capita equality shows that Indonesia is still a developing country. Therefore, Indonesia cooperates with other states in many sectors for the capability to manage and distribute. In the Soeharto era, when Freeport first came to Indonesia, iron ore resource found in Papua could not be managed optimally by Indonesia. The choice to cooperate with Freeport was most rational for Indonesia at that time (Tri Ratna Rinayuhani, 2017, p. 1922).

Basically, shares divestment policy was made to protect national interests from foreign states. However, in determining shares divestment, especially in the case of Freeport, the



Government has to measure or conduct a rational assessment on how many costs and benefits will be accepted if the divestment is conducted. A rational assessment conducted by the Government, regarding the costs and benefits of shares divestment, is the elaboration of Rational Choice Theory (RCT). RCT is a theory about the way humans decide their choices according to their personal inclinations. This theory aims to explain the behaviour of social systems in a small to large scale (Nicholas Abercrombie, 2010, p. 456).

RCT was first introduced by George Homas, a sociologist, in 1961 based on psychological behaviour (John Scott, 2000, p. 2). This theory developed into an economic principle in which every individual always makes logic and future-oriented decisions. These decisions give utility maximization for each individual. This theory concludes that people try to maximize their benefits in all situations, as well as minimize loss (Robert Nozick, 1993, p. 17). This conclusion is based on the thought that people make decisions from rational calculation, rational act, and aim to get satisfaction or benefits. RCT is used for decision making in policies, because this theory prioritizes beneficial and long-term decisions. There are two main elements of RCT, which are actor and resource. Actors will choose only beneficial actions. Actors will use half of their rights to control themselves and the other half to control other actors (Rendy R. Wrihatnolo and Rian Nugroho Dwidjowijoto, 2007, p. 103). Resources are objects controlled by the actor.

From the perspective of Investment Law, the main actor, highlighted by RCT, is the government and government actions related to the decision making for foreign investment policies in a state. In the case of shares divestment, the government should rationally assess the costs and benefits of the policy. The Government can control the resources in the state to be managed for the wealth of the people. Further, through shares divestment policy, the government has the role and opportunity to control investment policies to achieve the goal of the state.

By the existence of RCT, the government, in order to determine shares divestment policy, should measure how big the positive and negative effects will on the state if the policy is implemented. The hypothesis based on the implementation of this theory is formed from individual empirical experience (Thomas S. Ulen, 2009, p. 793) and thorough analysis of the available data. Data in this case is all facts affecting costs and benefits of investor actions. If after the assessment it is proven that a shares divestment scheme with the market price will not giving much benefit for the state, and tends to make a loss for the state, the government should change the shares divestment policy scheme.



The main purpose of RCT is that the attachment and relationship between host country and home country will create maximum benefit. RCT is the basis for which the government should bring maximum benefit for the host country by determining investment policy; economically and socially. Policies and decisions made by the government should be based on rationality; therefore the legal policy will prevent irrationality and inefficiency which cause loss. RCT is also related to the Government Intervention Theory (GIT). The implementation of RCT shall synergize with GIT. The role of government to intervene in the market is needed to correct the market imbalances to protect domestic sectors of the state. As a developing country, Indonesia still needs the government to control the infant industries to compete with industries in developed country (M. Zaidun, 2005; Takele, 2018).

The conclusion is the cooperation between government and foreign investors can only happen if there is the possibility of benefits for national interest of the state. As a developing state and a host country, the Indonesian Government should hold a comprehensive study regarding the costs and benefits, to determining shares divestment policy. A share divestment policy scheme should be clear, not only giving benefit in the short term, but also for the long term. The calculation of profit and loss should also consider the possible effects, to save this generation and the next generations.

From RCT and GIT, the government, in order to protect national interest, should take clear measures regarding the limits of what actions can be done by Freeport to prevent loss for the state, by determining share divestment policy for Freeport clearly, not by purchasing, but directly transferring the ownership to the Indonesian Government. “*Salus Populi Suprema Lex*” (*The welfare of the people shall be the supreme law*).

C. Recommendation for Mining Shares Divestment

First, deciding the clear mechanism for determining the divestment share price. The Indonesian Government and Freeport do not have to be fixated on two-existed-debatable-methods since there are plenty of methods for determining a divestment share price that can be adopted. As stated from NGRI research, there were recommendations that the Indonesian Government may follow different international appraisal rules based on the cases. Several mineral-producing countries already have standard and detailed rules regarding the valuation of mining assets, such as The Australian Institute of Mining and Metallurgy (VALMIN), the Canadian Institute of Mining, Metallurgy, and Petroleum (CIMVAL) and the South African Mining Associations (SAMVAL). Potential conflicts among stakeholders and uncertainty in determining the divestment share price in the mining sector can be reduced by imposing one of those international rules.



According to the case of *CMS Gas v. Argentine*, the Indonesian Government and Freeport should considerate the Discounted Cash Flow (DCF) Approach, which assesses company assets by determining the present value discounted at a rate that reflects the different categories of risk and uncertainty. In the case of *Rusoro v. Venezuela*, the Arbitral Tribunal decided to use maximum market valuation, book valuation, and adjusted investment valuation in determining the genuine value of the investment done by the foreign investor company in the host country. The Indonesian Government and Freeport should consider a combination of divestment pricing approaches according to each party, which are the replacement cost approach of the Indonesian Government and the fair market value approach of Freeport. Thus, the middle value of the combined approaches can be obtained and used as a reference for the divestment share price.

Second, eliminating the regulations concerning divestment. The implementation of the mandatory divestment of shares is not easy. Nevertheless, the authors recommend that the divestment regulation should be eliminated and replaced by other mechanisms in order to fulfil the ideals of the Indonesian nation, stated in The 1945 Constitution of the Republic of Indonesia, that the control of resources in the territory of the Republic of Indonesia is in the hands of the nation itself so that the people can take advantage directly from the control of the resources. The Indonesian Government should maximize the mining revenue through the royalties. The amount of royalty and its increases can be regulated in the legislation, which is easier to implement over divestment that requires the determination of the divestment share price.

Third, divestment without purchasing. The implementation of the divestment is hard to be implemented considering that neither the Indonesian Government nor the foreign investor companies in the mining sector reached an agreement in determining the divestment share price, in accordance with the interests of each party. Therefore, the divestment should be arranged at the beginning when the Business License is granted, as a direct liability without any financial compensation. Mining business undertakings may conduct business feasibility assessments under the terms of this direct divestment. Business undertakings may consider whether the investments made will be profitable or not at the beginning of the operating plan of the mining business activities carried out, including the calculation of the costs incurred by this direct divestment obligation.



Conclusion

Generally, divestment cases cannot be solved. This shows that there is a problem in the divestment mechanism which only focuses on monetary aspects from the foreign investor side. Further, this has not covered increased the peoples prosperity, sustainable development or environment eco social justice, in order to create national energy security. In the decision making process, especially decision related to political and economic condition of the state, there are 2 approaches that can be used. They are public choice theory and rational choice theory. These theories are created because economic and political regimes are contrary each other in the policy making process. The implementation of PCT on divestment policy can be conducted by taking decisions which will bring more benefit for the people. This is done by not changing divestment policy but it is conducted by making a clearer mechanism related to the determination of the divestment share price. Meanwhile, RCT can be used as a basic guideline for the state in making investment policy which should bring greater benefit for the host country, both from an economic and social standpoint. If it has been examined and it is clear that the divestment scheme, by buying the share with a market price, will bring more disadvantages, the Government needs to change that divestment policy.

This research finds three alternatives for the divestment mechanism in the mining sector. First, deciding a clear mechanism for determining the divestment share price. Second, eliminating the regulations concerning divestment; and Third, divestment without purchasing. This mechanism is in line with a means to increase state control over natural resources, especially for minerals and coal, and also as a mean to create a welfare state, an economic democracy, and national energy security, as it is regulated under Article 33 of The 1945 Constitution of the Republic of Indonesia.



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