The Inward Foreign Direct Investment (FDI) and decentralized governance system in Indonesia
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CHAPTER I. INTRODUCTION

1.1 BACKGROUND

The contributions that inward Foreign Direct Investment (FDI) has made towards the acceleration of economic growth within a host country’s government remain ambiguous. Many studies have found that inward FDI can enhance economic growth in a host country (Blostrom and Kokko, 1998, Rodriguez and Clare, 1996 and Graham and Krugman, 1991). Other studies have found the opposite results; according to OECD (2001), Pavlinek (2004), Galagher (2005), Figini and Gorg (2011) and Wei et al. (2009), inward FDI may increase a country’s dependency on foreign capital, destroy domestic enterprises, increase income inequality and deteriorating environmental quality.

The inward FDI will have significant contributions to economic growth in a host country when certain factors do exist. Several studies have found that the human resources capacity of the host country’s government (Boreinsztein et al., 1998, and Li and Liu, 2005) and the appropriate governance setting (Solomon, 2011) are factors which influence the levels of contribution of inward FDI on local economies. Because the governance setting is an important factor in the enhancement of the contribution of inward FDI on the development of local economies, further research on the appropriate governance setting on inward FDI is necessary.

Due to the importance of the governance setting to enhance the contribution of inward FDI on local economies, the research on the governance setting of inward FDI in Indonesia is thought-provoking. Indonesia is one of the top five recipients of inward FDI in Asia (UNCTAD, 2017c). Indonesia has abundant natural resources, a stable macro-economy, and huge market size (Tambunan, 2013); furthermore, since the economic crisis in 1998, Indonesia has undertaken significant regulatory reforms to improve its attractiveness and competitiveness in the global market. One of these substantial reforms was the introduction of the decentralized governance system in 2001, which provided the district government with a bigger role in the management of regional economic development.

Since the introduction of the decentralized governance system in Indonesia, there have been few studies which focus on the governance setting of inward FDI under the decentralized system in Indonesia. For example, studies on the legal investment framework in Indonesia, conducted by Rajenthraan (2002), and OECD (2010). Other studies conducted on inward FDI focus on the contribution of inward FDI on development; examples of these studies include
Pardjiono (2003), Shodiq and Nuryadin (2005), Effendi and Soemantri (2003), who examine the contribution of inward FDI to economic growth, and Lipsey and Sjolhom (2004), who examine the impact of inward FDI on social development in Indonesia. However, studies which emphasize specifically the dynamic interaction between national government, local government, and MNCs in the process of managing inward FDI in Indonesia remain absent or limited at best. Due to this limitation, the following dissertation is devoted to the analysis of the governance setting of inward FDI in Indonesia since the introduction of the decentralized governance system, with focus on the dynamic interaction between national and local government and MNCs.

The objective of this dissertation is to contribute to the conversation regarding the governance of inward FDI especially related to the relationship between the state and international business, which has become an important topic in the international political economy realm. Much literature on the relationship between government and international business paid little attention to the roles of sub-national government and focused heavily on the government actors, on a national level. For instance, Vernon (1978) examines the bargaining relationship between the national government and Multinational Corporations (MNCs) in many developing countries, from the 1960s to 1980s. Also, Behrman and Grosse (1990), Stopford and Strange (1991), and Dunning (1998) examine the interaction between the national host country government and MNCs from the 1990s to the 2000s. In fact, most countries in the world have implemented decentralization, which gives sub-national institutions greater power to manage their economic development (Manor, 1999). This phenomenon, in combination with globalization, has changed the relationship between government, international business actors, and non-state actors on international, national, and sub-national levels (Behrman and Grosse, 1990). The change of the relationship has not been theorized well in much literature recently, although decentralization, which gives the sub-national government more power to manage its regional economic development, has been implemented in many countries.

In an attempt to fill the theoretical gaps listed above, this dissertation analyzes the governance of inward FDI in Indonesia. More specifically, we focus on the strategies used by the government to achieve sustainable development from inward FDI, and on the dynamic interaction between host country (national) government, host country (sub-national) government, and MNCs (see figure 1.1 the triangular governance relationship). Illuminating the triangular governance relationship found in the inward FDI management can help policymakers to improve the governance system, to achieve a better quality of inward FDI,
and to help the managers of MNCs to adjust their business approach in response to global change.

We divide our analysis into four different empirical components (see figure 1.1). The first empirical component examines the institutional FDI framework in Indonesia. The analysis provides an understanding of regulatory frameworks which affect the interaction between actors in the process of managing inward FDI. It includes the analysis of regulations on investment, trade, and other economic policies. The second empirical component of this dissertation examines the relationship between the national and local government, in the managing of inward FDI. In addition, we analyze the factors which influence the success of the coordination mechanism in the decentralized system. Many studies have found that decentralization decreases the volume inward FDI in many countries in the world due to problematic coordination mechanisms. For instance, Yong (2008) found that decentralization decreases inward FDI in India, but not in China. Kessing et al. (2007) found that decentralization reduces inward FDI in sixty countries in the world, and Kalamova (2008) found that decentralization reduces inward FDI in the Organisation for Economic Co-operation and Development (OECD) countries. Nevertheless, these studies have lacked information pertaining to the factors which may have caused the coordination problems, and to possible solutions offered; in the second component of our empirical analysis, we examine the intergovernmental relations in managing inward FDI in Indonesia with the aim of complementing the research conducted before us.

In the third empirical part of this dissertation, we discuss the nature of the relationship between local governments and MNCs. In addition, this section examines whether or not a decentralized system increases the bargaining power of local government when having a negotiation with MNCs. Our argument lies on the postulate developed by Qian and Weingast (1997), who argue that decentralization increases the competition between regions for capital investment, resulting in the local governments’ cooperation with MNCs by providing more friendly investment policies. Also, under a decentralization system negotiation between local government and MNCs is unavoidable because the local leader and the MNCs must consider the local community’s interest in the economic development (Guthrie, 1997).

The fourth empirical part of this dissertation discusses the relationship between the national government of Indonesia and MNCs. This section analyzes the negotiation process between the host (national) country government with MNCs by considering the interest of the local community, local government actors, and pressure group. This analysis helps us to
understand the ways that MNCs respond domestic policy changes, the roles of the home country government in supporting the MNCs, and the influence of international investment regime on negotiation processes between the national government and MNCs.

Figure 1.1 The triangular governance relationship to manage FDI

1.2 INDONESIA AS A LOCUS OF STUDY: THE DECENTRALIZATION CONTEXT.

The objective of this dissertation is to understand how the inward FDI in Indonesia has been managed since the introduction of the decentralization system. It focuses on the strategies used by the government to achieve sustainable development from inward FDI, and the dynamic interaction between host country (national) government, host country (sub-national) government, and MNCs. Although these actors are the main actors to be analyzed, we also include additional actors, such as local community and supra-national institution, in the interaction process.

We select Indonesia as a locus of study due to the following characteristics: Indonesia has a globally emerging economy, is a member of G-20, and is a newly industrialized country which has successfully attracted FDI. Indonesia is also one of the top 20 recipients of FDI in the world, and the second biggest recipient of FDI in Association of Southeast Asia Nations (ASEAN) member countries along with Singapore (UNCTAD, 2014). Furthermore, Indonesia
is the third largest democratic country in the world, and it has transformed from the most centralized country into the most decentralized country in the world. As the Head of Subdivision for Foreign Enterprises Cooperation at the Ministry of Home Affairs office of Indonesia, I have had the privilege of being involved in the interaction processes between those actors. Therefore, this dissertation provides insights from internal actors.

Indonesian government consists of three levels of government: the national or central government, the provincial government, and the district or municipal government. Indonesia has been implementing a decentralization system since 2001, which gives the district and the provincial government greater power to manage regional economic development. Decentralization may be defined as a transfer of power, authorities, responsibilities, private companies or civil society from the national to sub-national government (Cheema and Rondinelli, 2007). In the beginning, decentralization in Indonesia was aimed to reduce the political tension of the rich natural resources such as Papua, Aceh, Eastern Kalimantan after the fall of Soeharto’s regime (Green, 2005). In its implementation, the law on decentralization has been changed two times since its introduction in 1999. Therefore, we divide the phase of decentralization into three waves: the first wave of decentralization (2001-2004); the second wave of decentralization (2004 - 2014); and the third wave of decentralization (2014 -present).

1.2.1 The first wave of decentralization (2001 – 2004)

The first wave of decentralization was implemented in 2001 after Law 22 on local governance (1999) was fully implemented. Under Law 22 (1999) the national government transferred all authorities to the district governments except six affairs as follows: the judicial system, fiscal and monetary affairs, national defense, national security, foreign affairs and religious affairs (Suwandi, 2015). The provincial governments had roles as coordinator of district governments and as representative of the national government at the local level (Law 22, 1999).

The national government devolved authorities to issue investment, and business licenses to the provincial governments include the foreign investment license (Presidential Decree 117, 1999). However, the investment license on the foreign investment in the high technology and high-risk sectors such as nuclear energy, genetic engineering, and weapon industry was issued by the national government (Government Regulation 25, 2000). To stipulate the investment license, the provincial government created the Indonesian Regional Investment Coordination Board, Badan Koordinasi Penanaman Modal Daerah (BKPMD). This agency had the following functions: (1) to advise the governor on stipulating the regional investment policies;
(2) to issue domestic and foreign investment licenses; (3) to monitor the implementation of investment projects.

1.2.2 The second wave of decentralization (2004 – 2014)

In 2004, Law 22 on local governance (1999) was replaced by Law 32 on local governance (2004) as a result of many issues in the economic development which had arisen as a result of the previous law (Ministry of Home Affairs, 2011). For instance, the conflict between the different levels of governments became more prevalent due to the unclear distribution of functions among the different levels of government. Likewise, there was local political instability because local councils in many districts abused its power to dismiss the district heads or mayor given by the law (Ministry of Home Affairs, 2011). In addition, the uncertainty, political instability, and increased corruption under the first wave of decentralization deteriorated investment and business climates in Indonesia (LPEM UI, 2002; World Bank, 2005).

Law 32 on local governance (2004) strengthened the roles of national governments and reformulated the distribution of authorities among national, provincial and district governments, based on three criteria: externality, efficiency, and accountability. Suwandi\(^1\) (2015) described the mechanism of intergovernmental relations during period of 2004 to 2014 as follows: the national government created standards, norms, and guidelines for provincial, district and municipal governments to provide public services; supervised and monitored the implementation of these standards; and provided training for provincial, district/municipal governments to carry out the public services. The provincial government had authorities implement the standards, norms, and guidance at the provincial level, and monitoring the implementation of the standards at the district level. The district or municipal governments used the standards and norms as a guideline in providing public services at the district level (Suwandi, 2015). In terms of FDI management, the national government took the authority to stipulate investment and business licenses for foreign investment from provincial government (Head of BKPM Decree No 57&58/SK/2004). The national government administered the licensing procedure for FDI through a national body called the National Coordinating Investment Board or Badan Koordinasi Penanaman Modal (BKPM). The provincial and district governments had the authority to provide some necessary permits related to the location of the inward FDI projects. However, in terms of investment promotion, provision of incentives for investment, infrastructure development, and development of information

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\(^1\) Suwandi made was Director General for General Government Affairs at the Ministry of Home Affairs and the head of the committee for the
systems of investment and monitoring processes, there must be cooperation between the national and provincial and district government (Government Regulation No. 38, 2007).

1.2.3 The third wave of decentralization (2014 – 2018)

In 2014, the law 32 on local governance (2004) was replaced by Law 23 on local governance (2014). Law 23 provided a more rigid division of functions between national, provincial, and district government (Ministry of Home Affairs, 2011). Many aspects of public services provision became the responsibility of the provincial government, instead of the district government; for example, education, health, waste management, mining, and tourism (Suwandi, 2015). More specifically, Law 23 divided the government's functions into three categories: the absolute functions, concurrent functions, and general functions. The absolute functions are defined as roles retained by the national government in the following six affairs: judiciary, fiscal/monetary affairs, national defense, national security, and foreign and religious affairs (Law 23, 2014). The concurrent functions are defined as roles which are shared among national, provincial and district governments (Law 23, 2014). The general governance function is an administrative function possessed by President as head of government administration such as manage national stability, resolve conflict, manage national unity, and maintain nationalism (Law 23, 2014).

In the management process of FDI, a national government agency, the National Coordinating Investment Board (BKPM) stipulates both investment and business licenses for FDI. However, the provincial and district government are also important parts of the investment licensing procedure. Those governments are responsible for stipulating location permits, environmental permits, land use permits, disturbance permits, and building permits as part of the whole licensing procedure processes (Head of BKPM Decree No 14 the Year of 2015).

1.3 PROBLEMS OF DECENTRALIZATION IN INDONESIA

After the decentralization have been introduced in 2001, several issues that have arisen. Those issues have driven me to conduct the studies on the governance of inward FDI in Indonesia or how the inward FDI has been managed since the introduction of the decentralized governance system. Our analysis focuses on the investment regulatory frameworks to achieve sustainable development and the dynamic relationship between the national government, local government, and MNCs. Some issues related to the management of inward FDI under the decentralized governance system are discussed in the following section.
During the period after the introduction of the decentralized system in 2001, there was little evidence that decentralization could enhance the contribution of FDI towards regional economic growth, which contradicts with the objective of decentralization (KADIN\(^2\), 2012). Data KADIN (2012) indicates that although the amount of inward FDI went to regions increased (see table 1.1), the ratio of total inward FDI toward regional GDP decreased over time, especially during the decentralization era (2001 – 2010). Other studies have shown similar evidence. For instance, Effendi and Soemantri (2003) found that the contribution of inward FDI on local economic growth occurred in a short-term, but not in the long term. Furthermore, Sodik and Nuryadin (2005) found that there is little evidence to support that inward FDI can accelerate regional economic growth. The lack contribution of inward FDI on regional economic growth has attracted me to examine the ways in which the national government drives both the investment policies and the roles of the district and provincial governments to attract and to steer inward FDI. More specifically, we are interested in exploring the way of district governments interact with MNCs to ensure benefits of inward FDI.

Table 1.1 Inward FDI in Indonesia, 1986 – 2015 ($ million)

<table>
<thead>
<tr>
<th>Centralization</th>
<th>After decentralization</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Years</strong></td>
<td><strong>Inward FDI ($ million)</strong></td>
</tr>
<tr>
<td>1986</td>
<td>258</td>
</tr>
<tr>
<td>1987</td>
<td>385</td>
</tr>
<tr>
<td>1988</td>
<td>576</td>
</tr>
<tr>
<td>1989</td>
<td>682</td>
</tr>
<tr>
<td>1990</td>
<td>1.092</td>
</tr>
<tr>
<td>1991</td>
<td>1.482</td>
</tr>
<tr>
<td>1992</td>
<td>1.799</td>
</tr>
<tr>
<td>1993</td>
<td>2.003</td>
</tr>
<tr>
<td>1994</td>
<td>2.101</td>
</tr>
<tr>
<td>1995</td>
<td>4.419</td>
</tr>
<tr>
<td>1998</td>
<td>-207</td>
</tr>
<tr>
<td>1999</td>
<td>-1.838</td>
</tr>
<tr>
<td>2000</td>
<td>-4.550</td>
</tr>
</tbody>
</table>


\(^2\)KADIN is the Indonesian Chambers of Commerce
Note: There is a significant increase in the amount inward FDI in the decentralization periods (2001 – 2015). In 1986 the amount of inward FDI was only $ 258 million, and it increased significantly to $ 4.7 billion in 1997. The inward FDI decreased significantly from 1998 to 2001, after Indonesia was hit by the economic crisis. After decentralization, the amount of inward FDI increased significantly again and reached $ 16.7 billion in 2015.

Figure 1.2 Inward FDI and Domestic Investment in Indonesia 1990 – 2010, (% Regional GDP).


Note: 1. The regional GDP is an aggregated number of the regional GDP in all provinces in Indonesia.

2. The graph indicates that there is a trend of decrease in the ratio of FDI on the regional GDP, which means that decentralization cannot increase the contribution of investment to the regional economic growth

Secondly, BKPM (2013) shows that the inward FDI projects remain centralized in Java-Bali regions, despite decentralization (see table 1.2). Under the decentralization era, some regions received a higher amount of inward FDI than they did during the centralization era. However, the difference is not significant. For instance, the inward FDI that went to the Sumatra regions during the decentralization era was higher than it was during the centralization era. There was also a slight increase of FDI during this era in the eastern areas, such as the Kalimantan and Sulawesi regions. This regional increase of FDI during the decentralization era has compelled researchers to try and understand whether or not decentralization can increase the roles of local government to influence the location decisions by the MNCs. A study of the dynamic relationship between the national, local and MNCs, which focuses on the dynamic interaction between the local government and MNCs, would be beneficial for future research.
Table 1.2 Distribution of inward FDI projects in Indonesia

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Projects%</td>
<td>Capital%</td>
<td>Project%</td>
<td>Capital%</td>
</tr>
<tr>
<td>Regions Sumatra</td>
<td>7.44%</td>
<td>2.13%</td>
<td>11.38%</td>
<td>18.93%</td>
</tr>
<tr>
<td>Regions Java-Bali</td>
<td>88.8%</td>
<td>97.16%</td>
<td>84.96%</td>
<td>72.59%</td>
</tr>
<tr>
<td>Region Kalimantan</td>
<td>1.30%</td>
<td>0.19%</td>
<td>1.29%</td>
<td>2.66%</td>
</tr>
<tr>
<td>Region Sulawesi</td>
<td>1.41%</td>
<td>0.10%</td>
<td>1.63%</td>
<td>3.36%</td>
</tr>
<tr>
<td>Eastern Region</td>
<td>1.03%</td>
<td>0.41%</td>
<td>1.15%</td>
<td>2.73%</td>
</tr>
</tbody>
</table>


Note: The inward FDI remains concentrated in the Java-Bali Regions. After the decentralization era, there was a slight improvement in term of the national distribution of the inward FDI across regions.

Thirdly, there is a significant change in the relationship between the national, provincial, and district governments, which caused the coordination problems due to decentralization. Many studies on intergovernmental relations such as Brojonegoro and Vazquez (2004) and Brojonegoro and Ford (2007) found that the coordination mechanism among national, provincial and district governments became more complex compared to the centralized period (prior 2001). The complex relationship leads to the ineffectiveness of policy implementation. A study by the World Bank (2005) found that conflicts between local and national regulations and overlapping of national regulations were considered to be the most significant issue in Indonesia during the decentralization era. Another example of coordination problem can be seen from the issue of over taxation, in which a company has to pay taxes levied by national, provincials and district governments. A survey conducted by LPEM-UI (2002) found that decentralization has driven local governments to levy taxes to many businesses in their regions, without considering the impact of these taxes on business activities. KADIN reported that there are about 1,006 local regulations which are primarily focused on the local taxations imposed for investors (Patunru and Wardhani, 2008). The coordination problems arise in the period of decentralization (2001 – 2017) has attracted me to explore more detail on the dynamic interactions between the national, provincial, and district governments, which are involved in the process of managing inward FDI in Indonesia.
Lastly, during the decentralization era (2001 – 2017), there were many conflicts involving the local communities, local governments, national government, and MNCs. For instance, the conflict between the government of Indonesia with Freeport Indonesia, Inc., between the government of Indonesia with Newmont Nusa Tenggara, Inc., and between the government of Indonesia with Churchil Mining, Inc. From these conflicts, we wish to understand the nature of the relationships between the national government and MNCs, under a decentralized system. More specifically, we are curious to examine why these conflicts still occur under the current globalized system in Indonesia, how the government and MNCs can resolve these conflicts and the significance of the roles of the sub-national institutions in the conflict-resolving process.

1.4 RESEARCH QUESTIONS

Depart from the above issues and theoretical debate, this study has come up with one overarching research question:

**How has Indonesia managed inward FDI since the introduction of the decentralization system?**

To answer this question, we need to first address the two following sub-research questions:

1. **How do the investment policies in Indonesia embody the concept of sustainable development?** This question seeks an explanation regarding the current governance setting in Indonesia and asks whether the concept of sustainable development has been adopted in the policies regarding the inward FDI. Furthermore, the answer exploration helps us to understand the Indonesian policies in the context of the inward FDI.

2. **What is the nature of the relationships between the national government, local government, and MNCs under a decentralized system in Indonesia?** This question seeks an explanation regarding the ways in which the national government, local government, and MNCs interact with the decentralized system in Indonesia. It examines the goals and interests of these actors, their resources and constraints, and the mechanisms of interaction in the management process of inward FDI, under a decentralized system. The answers to this question are crucial to understanding the roles that the international investment regime and supra-national institution play on the domestic actors’ attitudes toward MNCs, and the influence of decentralization upon the attitude of MNC’s actors towards their host country’s government. To fully explore this, we split up the analysis into three analytical themes to answer the following sub-research questions:
a) **How do the national, provincial, and district/municipality government actors interact with each other in managing inward FDI in Indonesia?**

This question seeks an explanation regarding the distribution of functions between three tiers of governments in the management of inward FDI, and their coordination mechanisms in carrying out these functions. The answer to this question will demystify the collaboration process between all levels of government which aims to overcome their shared issues, such as poor investment climates in Indonesia.

b) **What is the nature of the relationship between local governments and MNCs, with regards to inward FDI in the era of decentralized governance?** The answer to this research question provides evidence of the influence of the decentralization system upon the nature of the relationship between local government and MNCs. Furthermore, it portrays the ways in which the local government engages with MNCs to support regional economic development.

c) **What is the nature of the relationship between the national government and MNCs in the era of decentralized governance?** The question seeks an explanation related to the negotiation process between the government of Indonesia and MNCs in mining sectors. Furthermore, it also provides evidence that the globalization and decentralization have significant impacts on the relationship between the government and MNCs.
1.5 CHAPTER OVERVIEW

This dissertation consists of seven chapters. Chapter I of this dissertation provides information about the research background, the focus and locus of the study, the research objectives, research questions, and overviews of the overall chapter in the dissertation.

Chapter II of this dissertation provides an overview of the theoretical concepts of the governance of inward FDI and research design. We begin our overview of the theory of governance which includes decentralization, Multi-level Governance Theory, the theory of Foreign Direct Investment (FDI), bargaining theories, and concepts of sustainable development. From these theories, we develop our conceptual framework as the instrument of analysis with which we will answer the research question. This chapter also elaborates upon how the data and information are collected, analyzed and presented in the dissertation. Furthermore, we explain the reasons for choosing our methods and design.

Chapter III of this dissertation provides an overview about the policy framework on inward FDI in Indonesia. We analyze whether the concept of sustainable development has been embodied in the investment policies in Indonesia. As an analytical tool, we employ the Investment Policy Framework for Sustainable Development developed by UNCTAD (2012). The analysis focuses on the strategic and normative policies to achieve sustainable development from the investment.

Chapter IV analyzes the dynamic interactions between the national, provincial, and district/municipal governments in the process of managing inward FDI in Indonesia. More specifically, we analyze the division of functions to manage inward FDI among the various levels of government, and their mechanisms of coordination used to overcome the issue of poor investment climates in Indonesia. Our analysis utilizes the concept of multi-level governance, which is then applied to analyze the relationship between the national-provincial and district governments’ level by using Banyuwangi and Ogan Komering Ilir (OKI) districts as case studies.

Chapter V of the dissertation analyzes the nature of the relationship between local governments and MNCs under a decentralized setting in Indonesia. By utilizing the concepts of decentralization and political bargaining model and selecting Banyuwangi and Ogan Komering Ilir district as case studies, we examine the impacts of decentralization on the nature of the relationship between local governments and MNCs, specifically, the bargaining positions of local government when having the negotiation with MNCs. Furthermore, chapter
V portrays the ways that local governments engage with MNCs to ensure that their communities may benefit from inward FDI.

Chapter VI of this dissertation analyzes the nature of the relationship between the national government and MNCs within mining sectors in Indonesia. More specifically, we examine the negotiation process between the government of Indonesia and two MNCs which involving other actors such as local communities and local government officials. Although the focus of our analysis is the nature of the relationship between the government and MNCs, we also scrutinize the bargaining process between the home country government and host country government, in order to understand the relationship between the global regime and domestic policies used recently, using a two-tier bargaining model and selecting the negotiation process between the Government of Indonesia with Freeport Indonesia, Inc. and between the government of Indonesia with Newmont Nusa Tenggara, Inc.

Chapter VII of the dissertation concludes the empirical chapter by overviewing lessons from the empirical chapters. Furthermore, this chapter also reiterates the core arguments of the thesis and formulates answers to the research questions. In addition, it illustrates the contribution of this research to the current theoretical debate and provides policy recommendations for the national government, provincial government, district government, and manager of MNCs.