The role of multinational corporations in Indonesian economic development through foreign direct investment and international trade

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Abstract: This paper looks into the role of the multinational corporations in Indonesia from a historical perspective. There are a number of examples with regard to the role played by these companies and also the steps taken by the Government of Indonesia to regulate them. This paper concludes that the presence of multinational companies among others can improve the living standards of most of the local economy and provide income for the state with nearly 50% of Indonesia’s exports by multinational companies, although on the other hand, the presence of multinational companies has changed the political and legal order of Indonesia.

Keywords: multinational; Indonesia; foreign direct investment; FDI; exports.


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This paper is a revised and expanded version of a paper entitled ‘The role of multinational corporations in Indonesian economic development through foreign direct investment and international trade’ presented at 4th International Private Law Conference, Bangkok, November 14, 2013.

1 Introduction

Activities of foreign investment from developed to developing countries are mostly conducted by multinational corporations (MNCs). In conducting its activities, MNCs
invest their investment through the establishment of branch companies, subsidiaries, joint ventures, and affiliates in various countries. Foreign direct investment from MNC is considered as the most appropriate strategy to enhance economic development rather than foreign borrowing or purchasing a license, contract management and so on.

It is also interesting to note that MNCs are the main driving force or trigger behind globalisation. Through the activities of production, trade and investment, MNCs has actually created a global marketplace. MNCs however, dominate, control and supervise the materials, market access and development of new technologies. In addition, MNCs have also the ability to generate huge profits for the reduction of poverty in the world.

Most governments and international financial institutions stated that the investments made by multinational companies are seen as one key to the success of the integration of the global economy. The efforts made by the government of developing countries to attract foreign investment from multinational companies through liberalisation, tax concessions, strengthening the rights of investors (investors) has become one of the development policies in developing countries. Governments of developing countries, including Indonesia, are trying to attract multinational companies to invest because the assets are owned by multinational companies such as capital, technology and skills. This paper looks into the role of the multinational corporations in Indonesia from a historical perspective.

2 Multinational companies in Indonesia

One of the most important indicators for the success of foreign investment in a developing country is a strong influence of multinational corporations on the implementation of export, such as is the case in countries such as China, Mexico, Indonesia, Bangladesh, India and Malaysia.

Multinational companies are also an agent for the transfer of technology from industrialised countries to developing countries and become a bridge between developed and developing countries. The multinational corporations (MNCs) have been one of foremost economic, political and social influence in the world economy for many decades. As a response to its expansion, there have been historical important developments in the evolution of the international regime for investment, especially foreign direct investment (FDI). They include, for instance the creation of the World Trade Organization (WTO) and the subsequent negotiations of additional agreements with provisions concerning FDI. In 2007 subsidiary of multinational companies employed 82 million workers and exported goods and services worth more than 31 trillion dollars. Multinational companies are dominated by US companies, the European Union and Japan.

Over the last decade, Indonesia’s economy has grown at above 5% every year. This is encouraging news, especially since it is happening at a time when the rest of the world is experiencing an economic slowdown. In addition to the strong domestic consumption and government spending, robust investment especially FDI has played an important role behind such economic growth. On May 27, 2011, the Government of Indonesia issued its master plan for the acceleration and expansion of Indonesia’s economic development, which aims to transform the Indonesian economy into an ‘advanced economy’ by 2025. To achieve this goal, Indonesia requires substantial investment, a considerable portion of which is to be supplied by the private sector from both domestic and foreign investors.
Indonesia, especially since the ASEAN financial crisis in 1997, has become much more liberal in its economic policies to attract more FDI and multinational companies to increase its economic growth and to alleviate poverty in the country. In the field of foreign investment actually Indonesia has opened wide the door for multinational companies to put their capital into Indonesia.  

Since the issuance of the Law of Foreign Investment namely Law No. 1 of 1967, some multinational companies have invested in Indonesia, e.g., Freeport Sulphur Co. Incorporated, International Tel and Tel (ITT), Toyo Minister (Japan,) Unilever (UK/Netherlands), Good Year, Singer Sewing Machanine Co., Dumex (Denmark), BAT (UK), Philippine American Timber Company SA (Panama), Philips (Netherlands).  

The government issued the Law of Foreign Investment in the construction with the consideration that the sources from abroad can be used to cover the shortage of domestic capital without creating dependency on foreign countries. The presence of capital, technology and management expertise abroad is expected to help accelerate national development. In the implementation of the investment in Indonesia at this time there are two contradictory things on one side foreign investment has been done and it immediately suggests that government policies have succeeded in inviting foreign capital. But on the other hand it appears that the development of foreign capital controlled by multinational companies is becoming increasingly dominant that can be raised fears of dependence on multinational companies. Indonesia has so far not had any regulations and policies governing multinational corporations, except through the Law of Foreign Investment and the legal norms governing multinationals.  

Conflicts of interest between the Indonesian Government and the interests of multinational corporations raise many problems, especially with the state government does not have enough capacity, structures and laws to control foreign investment, making a weakness that makes the government has an inferior position compared to multinational companies. This is reinforced by the liberalisation of international trade and foreign investment made Indonesia should make policies that are not in line with the national goals that are essentially welfare for the people of Indonesia, for example, among others, in the field of employment policy, taxation, subsidy reductions in various sector and reduced protection of domestic entrepreneurs.  

Globalisation and economic liberalisation increases economic interdependence through international trade and FDI by MNCs. Liberalisation of international trade provisions relating to investments contained in the agreement of the WTO, in particular in the Trade Related Investment Measures (TRIMS) Agreement. The TRIMS Agreement has influenced the promulgation of the Act No. 25 of 2007 on investment. This act however is considered very liberal and open up opportunities for MNCs to play a role in the economic development of Indonesia.  

3 Multinational corporations as major players through economic globalisation of FDI and international trade  

Large multinational companies influence the liberalisation of international trade provisions contained in treaties, in particular the WTO, such as the General Agreement on Tariffs and Trade, the General Agreement on Trade in Services (GATS), Trade Related Aspects of Intellectual Property Rights (TRIPs), TRIMS and others.
Thomas L. Brewer and Stephen Young define multinational companies as follows:\textsuperscript{11}

“... an enterprise which owns (in whole or in part), controls, and manages value-adding activities in more than one country. In so doing it engages in production and/or services activities across national boundaries, financed by foreign direct investment.”\textsuperscript{12}

Multinational corporations (MNCs) have long been recognised as a legal entity that plays an important role in international investment and international trade. This role is very likely due to its financial strength. With the financial ability, law (trade) seeks international arrangements.\textsuperscript{13} Power and enormous wealth can indeed considerable impact. Robert Gilpin, a political expert, posits that the rising economic power of multinational companies has changed the structure and performance of the global economy:\textsuperscript{14}

“These giant firms and their global strategies have become major determinants of trade flows and of the location of industries and other economic activities around the world. Most investment is in capital intensive and technology-intensive sectors. These firms become central in the expansion of technology flows to both industrialized and industrializing economic. As a consequence, multinational firms have become extremely important in determining the economic, political, and social welfare of many nations. Controlling much of the world’s investment capital, technology, and access to global markets, such firms have become major players not only in international economic, but in political affair as well, and this has triggered a backlash in many countries.”

The rules that control the activity of multinational firms are necessary to bridge the differences of interest. The interests of the host countries, especially developing countries, typically are expecting an influx of multinational companies into the country’s territory in order to be able to contribute to its development.

Foreign investment is a process associated with the implementation and monitoring of income through the company’s facilities located in at least one country outside the State of its parent company. The government receives and manages the foreign investment. MNC is a company incorporated in many sectors that will affect the economy of the host state. MNCs can be said as well as a company that owns (in whole or in part), supervises and regulates the activities of its operations located in more than one country. The activities such as production activities and services that cross the national border are conducted and financed by FDI).\textsuperscript{15}

MNCs and foreign investment are something different when described but they have links with each other, both are in several different forms.\textsuperscript{16} Foreign investment grows and develops in the interests of foreign investment while the company grows and expands in numbers. MNCs and foreign investment have the same code. They are like ‘viruses’ that can move in response to new opportunities that benefit them. Subsidiaries established in several countries are the end product of foreign investment and are the operational arms of MNCs.\textsuperscript{17} Foreign investment is an important variable in determining a country’s economic growth, employment, income and flow of international trade. By dominating the global product and consumer goods, the MNCs have become the non-governmental actors which are very important in the international political order, which legitimises their ability to reduce the sovereignty of nation states.\textsuperscript{18}

There are thousands of multinational companies with hundreds of thousands of companies doing business around the world. These companies expanded its business
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Throughout the world mainly through FDI, which aims to control and oversee part or all of the marketing, or production facilities in other economies, such as capital investment in the services sector, the manufacturer/manufacturing or commodity. Foreign direct investment can be made by the companies through the purchase of existing businesses or establish new facilities (called ‘Greenfield Investment’). The expansion of multinational business around the world was often marked or done through mergers, takeovers, or mergers between firms of different nationalities.

Based on the importance of the development of multinational companies in every aspect of the global economy, trade, financing and technology transfer, the absence of international regulations on investment is something extraordinary. While there are bilateral, regional and multilateral cooperation agreements on multinational corporations and FDI, but there is neither regulation nor agreements that regulate multinational companies in a comprehensive manner.

According to Sysvia Ostry, in conjunction with multinational companies, international investment regime has several characteristics:

1. The right of establishment is that companies of all any nationality has the right to invest anywhere in the world.
2. The principle of national treatment. This principle requires that all governments in all countries should treat subsidiaries of FDI enterprises the same as they treat domestic companies.
3. The principle of non-discrimination. This principle requires that states cannot differentiate its treatment of companies coming from different countries.

These provisions should be applied in the policies of the government in its treatment of FDI and should be transparent. There are several key elements of multinational companies in relation to FDI namely:

1. Multinational companies have the power to oversee the decision making of companies abroad
2. Multinational companies with foreign investment set simultaneously to allocate materials (resources) including capital, technology, foreign entrepreneurs and management experts and market access for trade and production abroad
3. Multinational companies with foreign investment have activities that have a value-added from companies located in at least two different countries.

The growth of multinational corporations and FDI based on the application of theory and international economic impact in terms of FDI regulation can be seen from some of the basic policy instruments in the national, bilateral, regional and multilateral levels.

There are some important characteristics in the implementation of multinational corporations and FDI. First, a multinational company is a major exporter or importer of finished goods and services from home state and of subsidiaries or branches in the host state. Integrated firms are also managing and coordinating the flow of semi-finished products and services across the state’ borders. Second, the multinational company is a major source of invention or innovation in the world economy. Investment in research and development (R and D) on certain assets is the main reason for the internalisation of the know-how between companies. Multinational company will patent some inventions
(know how) and give license to his companies or domestic companies. Therefore, it is the interests of multinational corporations to protect its intellectual property rights (IPR). This interest is seen clearly in the inclusion of intellectual property rights issues into the multilateral agreement in the Uruguay Round Negotiations. Third, with regard to technology transfer by multinational companies, there is a difference of interest between the expectations of the host country in the transfer of technology from multinational corporations. Fourth, the multinational corporations play a leading role in global finance flows through foreign investment, the delivery of profits, dividends, royalties, payments management and currency exchange. Fifth, some multinational companies and large companies operate in an imperfect market competition. Sixth, the development of activities relate to the use of technology. It is estimated that 80% of foreign investment is in the field of information technology (IT).25

The above description shows clearly that the multinational companies have helped the world economic growth and influence the policy-making investment both domestically and internationally.26 Foreign investment by multinationals is also a means to encourage the development of international business. There are currently more than 500 largest companies in the world comes from the USA, European Union countries and Japan.27

Most developing countries and poor countries hope to develop their ability to attract and maximise the benefits of FDI in the development of their economies. Although the government of almost every state continues to impose some restrictions on FDI, most governments are aware that if they cannot attract direct investment, they will have difficulties in obtaining financing, technology and entry into international markets.28 Development benefits of investments made by multinational companies as a source of capital and technology for economic development, has enabled the host state to make profit and also the expenditure of foreign investment. The advantages obtained by the host state are the advantage in international trade. This advantage includes the economic benefits, namely the increasing capacity of the state to achieve optimal production by selling products on the bigger market, increasing competition (among other things by reducing monopoly power and lower prices for consumers by encouraging domestic companies to compete and become more efficient in the host state).29

International companies through foreign investment can play a role in international trade or create a new trade depends on the destination of FDI itself. When multinational companies set up production company in a foreign country in response to the presence of obstacles or barriers to trade that threatens exports, it can be said that FDI to replace international trade. Multinational companies have a very important influence in international trade policy with its role as the principal lobbyist. According to its character, multinational companies can influence government policy or countries by limiting the ability of the state or the government to freely perform movement of goods, services and capital passing national borders.30

Multinational companies are the actors for the development of global interdependence. Triad Block (MNCs USA, European Union and Japan) in fact can be more protectionists, since they apply non-tariff barriers or obstacles to trade and investment in order to restrict access to their internal market and give preferential treatment to certain partners or specific country with reciprocal benefits.31 The most important developments in international trade and foreign investment the dependence of international companies and national causes more opening the possibility for countries to formulate trade policies in the interests of multinational corporations. This is because the multinational company as a key player in international trade has given a great advantage
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or benefit for countries, especially developing countries and underdeveloped countries are improving the living standards through international trade.32

Multinational companies operating in the free world trading system is protected by the WTO.33 Although multinational companies are not formally included as decision-makers in the decision making process in the WTO, negotiators in the WTO trade from developed countries represent the interests of multinational corporations.34

4 The role of multinational corporations in Indonesian economic development through FDI

The presence of multinational companies in Indonesia through FDI has been happening long before Indonesia’s independence. Indonesia is a country made up of thousands of islands and is the world’s largest archipelago nation, with a population of approximately 223 million people consisting of various tribes.

Indonesia is seen by many as a prominent investment destination. This is because the country possesses potential in numerous areas, such as: resilient economic growth driven by domestic demand, a solid demographic dividend, as well as abundant natural resources. However, there are some challenges that need to be addressed, primarily in the area of regulatory and political frameworks, human capital, and infrastructure.

The long story of FDI in Indonesia began in 1924 when geologists from Standard Oil of California (now Chevron) were trekking through the jungles of Sumatra. Those early explorers found what became the Duri field, one of the biggest oil finds in Indonesia, ushering in a lasting and positive relationship for US companies in Indonesia. Today, leading American brands are a familiar sight in Indonesia. In consumer goods, Procter and Gamble as well as Johnson and Johnson are very well positioned in the market. 3M, as a diversified product manufacturer and Energizer, a battery-manufacturing company, own the most recognisable brands in their respective product areas within Indonesia.

Liberalisation of FDI in Indonesia began when Indonesia was under Dutch rule. Before the First World War, there was a lot of foreign investment in Indonesia, mostly by Dutch enterprises in the field of natural resources and agriculture, especially plantations and rubber plantations. Prior to 1920, the modern industrial sector is very small and largely owned by foreigners such as rice milling industry and the textile and industrial processing of raw materials from the plantation and mining. After 1920, outside the plantation and mining activities, there are two important industrial companies at the time and both are owned by foreign investors, namely cigarette factory owned by British American Tobacco and automobile assembly plants owned by General Motors.35 During this period, although there was only a few state-owned enterprises, their interest of the private companies in the Netherlands (as exporters of manufactured products and foreign investment companies investing in Indonesia at that time in the field or natural or mineral sector, especially in companies like Shell and Unilever.36

Entry and exit of FDI in Indonesia – around 1966 to 1994 – was marked by the policies of the New Order Government led by President Soeharto. At that time, Indonesia’s economy was being crippled because of the economic policy of the days of the previous president, the president Sukarno. Indonesia faced economic crisis. Inflation could not be controlled. Indonesia was completely collapsed so that the debt was very large, foreign currency exchange was very low, a very large trade deficit and the influx of
loans and credit was very difficult. Indonesia at the time was in dire need of capital for development and financing of imports. When the Sukarno regime fell, the western countries and international economic institutions like the World Bank acted to help to restore Indonesia’s economy through the injection of cash grants, loans and grants, and an advisor to help shape the Indonesia’s economy.

During this period, the Government of Indonesia re-implemented the economic policies that was more open to private companies in general and foreign investment, especially multinational corporations. To attract FDI, Indonesia in 1967 was enacted the Law No. 1 of 1967 on Foreign Investment.

The fall of the Soeharto regime change brought new economic and political democracy in Indonesia. Under the Government of Megawati and Susilo Bambang Yudhoyono, Indonesia is still sticking to the liberal policy of foreign investment. The presence of multinational companies in Indonesia is still recognised and their role in increasing trade and investment is getting bigger. This policy can also be seen from the inclusion of the multinational company in the Government Regulation No. 7 of 2005 on National Medium Term Development Plan of 2004–2009 especially under Chapter 17 on Increasing Investment and Export Non-Oil and Gas, which states that:

“In relation to the increase in exports, it is necessary to formulate strategies and policies that take into account the presence of TNCs as FDI has a double benefit. First, TNCs have a strong logistics network international so as to encourage greater access to export markets, and second, TNCs is a potential source for production technology transfer and competitiveness of domestic manufacturing industry.” 37

Even in 2007, the government promulgated the Law No. 25 of 2007 on Foreign Investment which replaced Law No. 1 of 1967 on Foreign Investment and Law No. 6 of 1968 on Domestic Investment. This law is promulgated as the implementation of the multilateral agreements of the WTO. The legislation was however considered very liberal legislation.

FDI in Indonesia has shown rapid growth after a slight decline in 2009, due to the global economic slowdown. It continues to increase, providing further evidence of Indonesia’s economic resilience and attractiveness as an investment destination. Some foreign companies, such as Shell Oil and Standard Oil Company, established their presence in the country in the early 1900s. After the country achieved its independence in 1945, the government tried to encourage FDI from various countries as a means of economic development. One of the significant milestones of such efforts was through the establishment of Foreign Investment Law No. 1/1967, which stipulates that foreign investors can invest in the country in certain sectors which were not closed to foreign equity participation. Additionally, foreign investors could avail of a number of investment incentives, such as tax allowances and guarantees. Furthermore, since 2000, the country has opened more sectors and tried to establish a more viable investment environment. Because of these gradual improvements in liberalisation, Indonesia’s accumulated realised FDI stock has reached nearly USD 175 billion in 2011 38.

Indonesia is a country whose economy is largely dependent on foreign investment. The monetary crisis in 1997 and the decline in FDI into Indonesia greatly affect the stability of the Indonesian economy. 2000 to 2003 was a very poor year for FDI in Indonesia, the new climate in 2005 FDI in Indonesia rose, balance of payments data showed a 79% increase from the flow of FDI worth US$9 billion in 2005. In 2006, FDI of the USA was $6 billion and domestic investments worth US$2 billion 39. Most foreign
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Investors were approved by the Investment Coordination Board (BKPM) came from Asian countries such as Malaysia, Singapore, Korea, and Japan, and in 2004 began to enter Chinese companies to invest in other foreign investors Indonesia. Sedangkan derived of European countries including the UK and the Netherlands about 15% between 2005 and 2006.40

Investments made by multinational companies as a source of capital and technology for economic development, have brought capital receiving countries to benefit and also expenditure of foreign investment. Benefits derived from the capital receiving countries foreign investment is open economic advantage in international trade, which increased the ability to achieve optimal production by selling products in larger markets, increased competition (such as reducing the monopoly power and lower prices for consumers by incorporating domestic companies to compete and become more efficient in the industry capital recipient country).41

The growth of multinational companies through foreign investment in Indonesia and its impact on productivity in the industry or manufacture have started in the early 1990s and continues to grow until the Indonesian monetary crisis, even after the monetary crisis. Despite this condition, the presence and existence of multinational companies are growing in numbers through the establishment of subsidiaries or the establishment of a branch or by joint ventures with private companies to national and state-owned enterprises. According to Central Bureau Statistics Indonesia, the presence of multinational corporations continued to grow between 1986 and 1997 with an average increase of 20% and increased again after a further opening of foreign investment opportunities in Indonesia after the fall of the New Order era.42

The increasing existence of multinational companies today is very clear, especially after the deregulation in 1992 and in 1994 and the signing of a letter of intent between Indonesia and the IMF. The latter requires the opening or removal of barriers to foreign investment and international trade and allow the ownership of shares foreign investors 100% without any requirement for transfer to national companies both private and national or state-owned enterprises.43

The increasing presence of multinational companies, especially in the era of reform (under the Susilo Bambang Yudhoyono’s administration), continues to grow, especially in heavy industry sectors with industry-ownership through mergers or acquisitions, this for example, happens at Japanese companies including Honda, Nissan, Daikin, Suzu, Hino and Toyota. In addition, the company also controls a multinational plastics and steel industry.44 The presence of multinational companies in Indonesia is also increasing jobs. In 2000 and 2005, the job opportunities increased by 17%. Indonesia labour in multinational corporations increased, especially in processed food industry, textiles, steel products, footwear, chemicals, rubber, plastics, outer clothing, electrical products and transportation equipment. Labour productivity is needed, especially by multinational companies operating in heavy industry with a majority shareholding in the company or plant. As for the ownership of multinational companies in Indonesia in addition to the ownership of 100% there are also many which have majority ownership of approximately 90%–100%, 50%–89%.45

For Indonesia, the positive impact of the presence of multinational companies especially on improving the living standards of people who worked chiefly in factories owned by foreign companies or multinational companies. The companies pay higher wages than firms or factories owned by private companies nationwide. Multinational
firms pay higher wages not only for skilled or educated labour but also pay more to workers in labour-specific education levels. Multinational firms also affect domestic companies which have to compete with multinational companies with substantial capital and international markets. Because multinationals tend to pay high wages for educated workers or who have specific expertise local residents are encouraged to further enhance their education to a higher level.

In the field of international trade, the presence of multinational companies in Indonesia plays an important role, this is due in part to exports from Indonesia to other countries is carried out by multinational companies with their ability and mastery of a wide network.

Export opportunities by multinational companies are also due to government policy in most developing countries including Indonesia to give preferential treatment to these companies. This is the main reason as to why multinational companies to export-oriented. Approximately 50% of Indonesia’s exports are conducted by multinational companies, especially in food processing, lumber and furniture and chemicals including rubber and plastics, tobacco, steel and steel products of leather and textiles.

For Indonesia, MNCs are a more attractive means of developing technology in their industries than is obtaining technical licenses or other sources. The reason for this preference for MNCs over other sources of technology transfer is that with the latter, technology is provided, whereas with the former, it involves continuous interaction between the acquirer and the supplier of technology, and such continuous interaction is important for effective technology transfer since tacit knowledge is a component of virtually all technologies, and at the same time it is a long-term and difficult process. Therefore, for firms in developing countries, transfer of technologies through cooperation with MNCs is not only easier but also a better learning process than through, for example, imported capital goods.

Consequently, the presence of MNCs will result in an increased technology gap and hence development dualism within SMEs. Here then, the role of the government is crucial. Its SMEs development programmes should focus on capacity-building in less technological advanced SMEs. Also, to have an optimal spill over effect, a strong cooperation between the few SMEs as the first technology recipients and the rest of SMEs should be in place and, here again, the role of the government is very important as the main facilitator.

In addition to the transfer of technology, there are also some other impact caused by multinational companies, e.g., from the USA. For example, the impact of US FDI extends far beyond simple dollar figures. It creates jobs and builds a skilled workforce, grows markets, enhances social responsibility, instils best corporate practices, transfers technology and forges partnerships between international companies and the Indonesian people. A study found that the surveyed American companies in Indonesia directly employ approximately 183,000 people, at competitive salaries; the average wage paid per employee by the companies in the study is IDR 4.4 million per month, a figure higher than the legal minimum wage anywhere in Indonesia. While the popular perception often seems to be that US companies prefer to hire expatriates at a steep premium over locals, the study proves that this is a misconception. Comparative employment data for the period 2007 to 2012 from the respondents shows a trend strongly in favour of domestic employment, with the number of local employees nearly doubling over that period. At the same time, the number of expatriates employed by these companies in 2012 is only one-fourth the number it was in 2007 despite the growth in investment.
5 Concluding remarks

The actual presence of multinational companies in Indonesia through foreign investment has played a major role in the development of Indonesian economy. The presence of multinational companies can improve the living standards of most of the local economy and provide income for the state with nearly 50% of Indonesia’s exports by multinational companies, although on the other hand the presence of multinational companies has changed the political and legal order Indonesia.

Notes


4 Id, hlm 176.


7 The impact of US Foreign Direct Investment on the Indonesian Economy, Ernest and Young, USAID, August 2013, p.c.


9 Sumantoro, Bunga Rampai, op.cit., hlm 150.

10 Sumantoro, Bunga Rampai, op.cit., hlm 150.


37 The impact of US Foreign Direct Investment on the Indonesian Economy, Ernest and Young, USAID, August 2013.


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46 Eric D. Ramstetter dan Fredik Sjoholm, Idem, hlm 52.

47 Eric D. Ramstetter dan Fredik Sjoholm, Idem, hlm 52.


49 bid., 98.

50 The impact of US Foreign Direct Investment on the Indonesian Economy, Ernest and Young, USAID, August 2013, p.i.