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A Tale of Two Cities: The Political Economy of Local Investment Climate in Solo and Manado, Indonesia

Arianto A. Patunru, Neil McCulloch and Christian von Luebke

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A Tale of Two Cities: The Political Economy of Local Investment Climate in Solo and Manado, Indonesia [1]

Arianto A. Patunru, Neil McCulloch and Christian von Luebke

Summary

There is little doubt that orthodox institutional prescriptions, such as the protection of property rights, low corruption, and effective public services are desirable long-term objectives for all countries. But it is not clear whether implementing such prescriptions is sufficient, or even necessary, to achieve investment and growth. By taking a deeper look into the political economy of the cities of Solo and Manado in Indonesia, this paper shows that relationship-based, rather than rule-based, cooperation between government leaders and local firms can provide an effective mechanism to boost investment and improve local investment climates. In the case of Solo, a 'heterodox symbiosis' between public and private actors – involving the mayor and a broad spectrum of multi-sectoral/scale/ethnic firms – has brought about important regulatory and administrative reforms and contributed to a rise in private investment. On the other hand, Manado's government is characterised by a poorly planned, rent-seeking bureaucracy. At the same time, exclusive informal relationships between Manado's leaders and a small number of influential businessmen have facilitated a high level of investment and growth. Our study therefore challenges the conventional wisdom that impartial rule-based economic governance is a precondition for investment, although it suggests that the creation of such institutions may be necessary to sustain growth in the medium term.

Keywords: political economy; investment climate; sub-national governance; Indonesia.

1 With apologies to Charles Dickens.

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Acronyms

BI	Bank Indonesia
BPK	Supreme Audit Agency
DPRD	Dewar Perwakilan Rakyat Daerah
FDI	Foreign Direct Investment
GTZ	Deutsche Gesellschaft fur Technische
KAPET	Kawasan Pengembangan Ekonomi Terpadu
KPK	Corruption Eradication Committee
LPEM-FEUI	Institute for Economic and Social Research – Faculty of Economics, University of Indonesia
MSMEs	micro, small and medium sized firms
OSS	One Stop Shop
PDIP	Partai Demokrasi Indonesia Perjuangan
PKL	Pedagang Kali Lima
SMEs	small and medium enterprises

1 Introduction

Investment is needed for growth. This maxim has given birth to the mantra of ‘improving the investment climate’, championed most notably by the global donors (e.g. World Bank 2008; UNCTAD 2007, and DFID 2008). The exact definition of the ‘investment climate’ varies. Some use it to mean regulatory reform (e.g. World Bank 2008). Others include public sector engagement issues (e.g. World Bank 2006), or political stability and macroeconomic policy (e.g. World Economic Forum 2007). However defined, the underlying hypothesis of the related literature is clear: cutting the costs and risks of doing business will yield higher investment and economic growth. In practice, there is a substantial divergence between adherence to orthodox investment climate reforms, and economic performance. Some countries have pursued ‘Washington Consensus’ reforms and gained little; whilst others have pursued heterodox policies and experienced rapid increases in investment and GDP (Rodrik 2007).

There are several possible explanations for this diversity. First, economic policy is not the only factor that drives investment – differences in rates of investment and growth between different countries, or indeed between different regions within countries, may arise because of differences which have little connection with current investment climate policies, notably geography, factor endowments and history. Second, it may be that countries and regions that succeed in boosting investment do so because they successfully identify the ‘binding constraint’ to growth and investment in their particular context. Rodrik *et al.* (2007) argue that many East Asian countries achieved rapid growth because they were able to tackle the most critical constraints that they were facing at each point in their development.

This paper puts forward a third factor which may determine investment, namely, that countries or regions within countries, may succeed because of an effective coalition between key public and private sector actors. Indeed, it may be the establishment of such a coalition that enables countries to identify and address the binding constraints that they face. Moore and Schmitz (2008) argue that in many developing country contexts, investment is spurred more by narrow particularistic relationships between the two sectors, rather than by the creation of an improved investment climate for all. We attempt to shed empirical light on their argument by examining how the nature of the relationship between the public and private sector determines investment performance. Our central question is therefore ‘is investment driven primarily by a better general investment climate, or by the particular relationships between key private and public sector actors?’

Answering this question across countries is difficult because of the enormous variation of the other potential causes of differential performance. One way to try and isolate the more political or relational determinants of investment from other factors is to use within-country studies, comparing regions similar in geography, resource endowments and population, but different in approaches to local economic governance and in managing the relationship between the public and private sectors. Case studies in each region can then focus on how the approach pursued in each region has influenced investment performance. The regions chosen must have a significant degree of policy autonomy so that their performance could be considered the consequence of the choices they have made. Such case studies should therefore be done in countries with a significant degree of political and economic decentralisation.

Indonesia is one such country, as it underwent a massive decentralisation in 2001. We therefore examine the political economy of investment in two cities in Indonesia: Manado in North Sulawesi and Solo in Central Java.[2] We compare the investment climate in both cities and explore the nature of the alliances between key public and private sector actors and how these have affected the investment and growth performance observed. We find that local policymaking does have an important influence on investment, but that it does so primarily through actions to reduce the risks faced by a small group of large investors with close personal relations with senior policymakers, rather than by reducing the costs of doing business for the private sector more broadly. However, more inclusive policymaking and institution building may create a more sustainable platform for long-term investment.

Our paper is structured as follows. The following section provides a brief review of the literature on the determinants of investment, as well as the political economy literature regarding factors that determine the nature of the local investment climate. Section 3 elaborates the Indonesian context of the study. Section 4 introduces the conceptual framework for our study, whilst Section 5 explains the practical methodology used for the case studies. Section 6 describes the investment climate in the cities of Manado and Solo along the dimensions introduced in the conceptual framework, and Section 7 lays out some of the underlying political economy factors that may have given rise to the investment climates observed. Section 8 then describes the actual economic performance of the two cities in recent years and Section 9 concludes.

2 A brief literature review

The literature on the determinants of growth at the national level is immense (see Barro and Sala-i-Martin (1994) and Barro (1997) for key contributions; Kong (2007) provides a recent review). However, the literature on the political and policy determinants of private investment is somewhat more sparse and focuses heavily on understanding the causes of Foreign Direct Investment (FDI). Perhaps unsurprisingly, this literature emphasises the importance of location endowments such as good human capital, infrastructure as well as access to natural resources, as the main determinants of Foreign Direct Investment. But the role of policy in creating a good investment climate also features strongly. For example, Deichmann *et al.* (2003) show that FDI in Eurasian transition states is driven both by human and social capital, and good infrastructure, as well as a favourable investment climate, including trade policies and market reforms. Sekkat and Veganzones-Varoudakis (2007) show that investment climate reforms are complementary to increased openness in attracting FDI to developing countries.

2 In doing this, we draw upon our earlier case studies of the political economy of investment in Manado (McCulloch *et al.* 2009) and Solo (von Luebke *et al.* 2008).

Political risk and uncertainty also feature strongly in the literature on FDI. Root and Ahmed (1979) show that political stability is an important determinant of FDI in developing countries, and find that investors appear to be attracted to countries whose governments directly participate in infrastructure and industrialisation programmes. More recently, Rahim (2007) uses an economic freedom index as a proxy for the quality of the domestic investment climate for a sample of seven East Asian countries between 1995–2000 and finds that economic freedom is a significant and robust determinant of FDI. Similarly, Negishi (2007) highlights the role of political risk factors as a driver of foreign direct investment in East Asia and conducts a simulation exercise which suggests that stable government that reduces uncertainty can significantly increase FDI.

The broader literature on the investment climate confirms the importance of policy for firm performance. Dollar, Hallward-Driemeier and Mengistae (2005) show the strong relationship between the investment climate and firm performance. Chinese cities that have created good investment climates, in the sense of reducing bureaucracy and corruption and providing appropriate infrastructure and financial services, tend to produce more value from given capital and labour, pay higher wages and earn higher profits (see also Hallward-Driemeier, Wallsten and Xu 2006). Indeed Weiss (2008) has used firm-level panel data from China to control for geography and infrastructure and thereby rank the impact of provincial policy on firm productivity and profitability.

The literature therefore confirms that the investment climate is an important determinant of private investment. But investment also thrives in some environments in which the general investment climate appears to be poor. Some recent research sheds light on how relationships between key private and public actors can provide a ‘good enough’ investment climate for selected actors to drive investment. For example, Wang (2000) shows that informal institutions and networks of personal connections (*guanxi*) play a major role in facilitating FDI in China, by complementing and compensating for the weak Chinese legal system. Wilson (2008) explores how the relationships between foreign actors and state officials have changed the Chinese International Economic and Trade Commission, both helping to construct formal investment climate institutions, and simultaneously using *guanxi* to circumvent central regulations. Similarly, Choi (2008) examines the benefits that can accrue to firms that share overlapping interests with local governments in China.

Abdel-Lateef (2008) provides a comprehensive examination of common interests between policymakers and private investors in the food and furniture sectors in Egypt. She finds that these relationships can play a critical role in attractive investment to the sectors by providing proxy benefits such as protection of property rights, provision of support services and infrastructure and the reduction of uncertainty. However, she stresses that such relationships are not the sufficient in themselves to cause investment. Malesky and Samphantharak (2008) provides an econometric analysis of private investment in Cambodia’s provinces, showing the critical importance of political uncertainty in determining private investment.

Finally, it is important to understand why some locations have a good investment climate whilst others do not. Public administrations to obstruct private economic activities through distortionary regulations, superfluous administrative requirements, and illegitimate rents (e.g. Djankov *et al.* 2002). This view finds support in three different currents of thought: literatures on public-choice saying that bureaucrats pursue private rather than the public interests (e.g. Tullock 1965), the state-failure literature that demonstrates how state regulations (trade quotas, permits and taxes) are misused for rent-seeking purposes (e.g. Krueger 1974), and the literature on how bureaucracies with unconstrained powers are especially prone to corruption (e.g. Shleifer and Vishny 1998). Given the tendency of public administration to extract such rents, what are the countervailing forces that lead to the provision of public goods in efficient, responsive and non-corrupt ways? The forces offered in the literature are sub-national competition in decentralised regimes (e.g. Weingast 1995), interest group pressures (e.g. Becker 1983), and government leadership (e.g. Williamson 1994).

The subnational competition approach has its roots in Tiebout’s idea that people are likely to move to locations that serve their preferences best (Tiebout 1956). This induces local governments to compete for mobile asset holders by means of effective service provision and efficient revenue management. Besley and Case (1995) apply this approach in the context of local politics and argue that, under decentralisation, rational citizens can compare local politicians with counterparts in other districts and vote out officeholders once they fall distinctly below comparative yardsticks.

While subnational competition is characterised by ‘individual escape’ (by voter or by votee), interest group pressure prompts collective action. Olson (1965), however, has warned that collective action might not always work for the majority as larger groups are often less effective in coordinating their interests due to high transaction costs and free-rider problems. Bardhan and Mookherjee (2000, 2002) exploit Olson’s idea in their model of local political capture. They show that lower voter awareness and a more concentrated distribution of interests at the local level might give rise to higher local level capture. But there are also potential countervailing forces, e.g. heterogeneity across districts with respect to levels of inequality and poverty will tend to increase capture in high inequality districts but to lower it in low inequality districts. They conclude that the extent and causes of local capture need to be determined empirically.

Useful insights about the extent and manner in which interest groups at the local level may influence policies can also be obtained from Grossman and Helpman (1994). They develop a model in which special-interest groups make political contributions in order to influence an incumbent government’s choice of trade policy. The interest groups bid for protection with their campaign support. Politicians maximise their own welfare, which depends on total contributions collected and on the welfare of voters. The authors study the structure of protection that emerges in the political equilibrium and the contributions by different lobbies that support the policy outcome. Empirical studies of trade protection in the USA have provided empirical support for the Grossman and Helpman model (Gawande and Bandyopadhyay 2000; Goldberg and Maggi 1999).

While subnational competition and interest group pressure approaches focus on the demand-side factors of public service provision, the third approach, government leadership, offers its countervailing factor from the supply side. It focuses on the extent to which governmental 'top-managers' play a role in securing an adequate supply of public goods. In this case citizens' feet and voices resemble consumer power. Studies done in Latin America (Harberger 1993; Diamond and Linz 1989) and Asia (Ahrens 2002; Rodrik 1996) have confirmed that the quality of leaders matter a great deal. Some scholars have also warned of the detrimental effects of poor leadership in some African countries (Gray and McPherson 2001). The common theme running through all these accounts from Asia, Latin America and Africa, is that government leadership – be it for good or bad – makes 'a critical difference in the introduction, scope and pursuit of policy reform' (Grindle and Thomas 1991).

3 The Indonesian context

Indonesia, the world's fourth largest country has undergone a remarkable transition over the last ten years. For more than 30 years it was governed by a highly centralised authoritarian regime under President Suharto. Economic performance was extremely good with growth averaging 7 per cent per year and one of the fastest rates of poverty reduction in the world. The Asian crisis and growing corruption within the regime led to the downfall of Suharto in May 1998. Since 1998 Indonesia has made a rapid transition to greater levels of democracy culminating with the direct election of the current President in 2004.

After the collapse of the New Order regime, the demand for a more democratic environment was met by issuing new laws and regulations, including those dealing with freedom of the press, anti-corruption and elections. Pressure from regional governments for greater autonomy led to a reshaping of the relationship between central and local governments reflected in the issuance of Law 22/1999 (the Regional Autonomy Law) and Law 25/1999 (Fiscal Balance between the Centre and Regions). These came into force in 2001 with the result that administrative, fiscal and political control over several aspects of policy was devolved to over 480 district level governments.[3] More than 30 per cent of government expenditure is now done by regional (province and district) governments, with very large increases in district government budgets over the last few years. Each district also now has its own parliament, *Dewan Perwakilan Rakyat Daerah* (DPRD), with representatives elected by the general population, and, since 2005, direct election of the district head. Districts are responsible for most service delivery, local road building, and much regulation of the local economy.

However, decentralisation has also brought with it a plethora of new district level business regulations issued by the local parliaments. Whilst these are supposed to be consistent with national principles and are reviewed by the provincial and

3 Power was deliberately decentralised to the districts rather than to the 32 provinces in order to counter secessionist aspirations among some provinces (Hoffman and Kaiser 2006). Central government still retains control over defense, national security, foreign policy, monetary policy, finance, development planning, justice and the police.

central governments, several commentators have raised concerns that their principal aim is to raise local revenue (Lewis 2003) and that they harm the local investment climate (Ray, 2003; SMERU 2001, 2002, 2003).

It is not clear the extent to which this increase in local taxes and charges has affected the local investment climate. For example, a survey by Lembaga Penyelidikan Ekonomi dan Masyarakat-Fakultas Ekonomi Universitas Indonesia [the Institute for Economic and Social Research – Faculty of Economics University of Indonesia] (LPEM-FEUI) among business respondents in more than 60 districts, seemed to suggest that firms were more troubled by poor infrastructure and the need to make illegal payments than by increased local bureaucracy (LPEM-FEUI 2002a). Similarly the World Bank's Rural Investment Climate Assessment (World Bank 2006) shows that top of the list for micro and small firms are basic infrastructural concerns including road access and the cost of transportation, as well as problems in accessing credit. A recent survey of economic governance across 243 districts shows that only 12–14 per cent of businesses regard local taxes and charges as a major burden on their activities (KPPOD/The Asia Foundation 2008). A similar picture emerges from the Business Climate Survey conducted by Deutsche Gesellschaft für Technische GTZ in Central Java, with only 15 per cent of firms saying they experienced problems with user charges and fees, whilst many more mention infrastructure constraints (GTZ 2008).

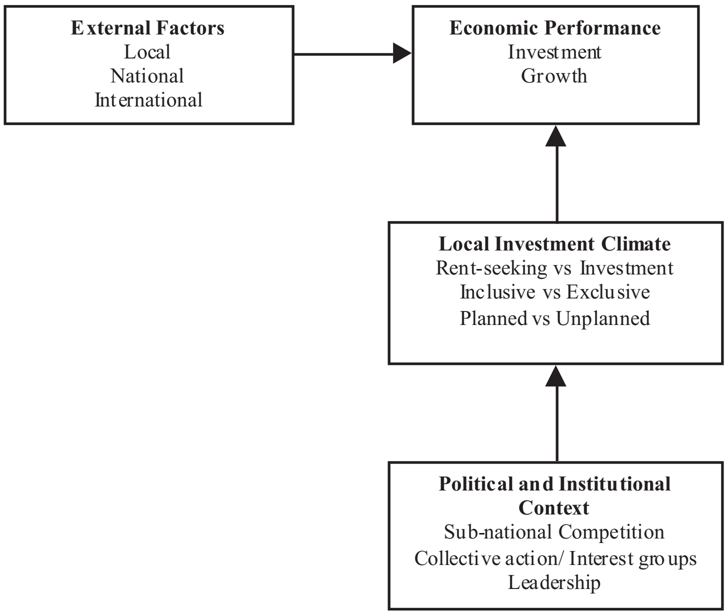
Moreover, there does not appear to be a clear relationship between the local investment climate and economic performance. Another study by LPEM-FEUI (2002b) in six major cities representing industrial clusters, found little correlation between economic growth and the investment climate. The city of Malang, for example, had one of the best investment climates according to the earlier survey, yet its growth was lower than that in the other five cities. In contrast, Palembang, which had a poorer business climate than Malang, grew significantly faster. As Basri and Patunru (2008) argue, improving investment climate may be necessary but it is *not* a sufficient condition for investment and growth.

The complex environment created by Indonesia's decentralisation creates a major challenge for Indonesia's policymakers, both national and local. Ironically, it also presents an important opportunity for researchers interested in the political economy of the investment climate. Under Suharto's centralised state, policy was uniform across the country. This ensured coherence and certainty, but also stifled local innovation. Decentralisation has allowed district government to innovate and experiment creating considerable variation in the quality of the local investment climate. This presents an opportunity to explore whether economic success at the district level is driven by efforts to improve the local investment climate for all, or by the particular nature of relations between key private and public sector actors.

4 Conceptual framework

Figure 4.1 shows the framework used in this study. The economic performance of a region, in terms of investment and economic growth, is assumed to be determined by both external factors and the local investment climate.

Figure 4.1 Conceptual framework for study



External factors include natural resources endowments, the level of human capital, geographical location, and the quality of infrastructure. Some of these are amenable to local policy in the medium-term, but many are entirely exogenous or influenced only by national level policies. Recent work suggests that such external factors explain remarkably little of the divergent performance of Indonesian districts (Fitrani 2005; McCulloch and Sjahrir 2008). We therefore offer a characterisation of local investment climate along three different dimensions: rent-seeking vs investment facilitation; inclusive vs exclusive relations and; planned vs unplanned development. These dimensions are then contrasted with three factors that might affect them: sub-national competition, interest group pressure, and local leadership.

The first dimension relates to whether the local government focuses on extracting rent from the private sector without considering the effect on private investment (we call this 'rent-seeking'), or whether it focuses instead on maximising growth and investment with relatively low rent extraction ('investment-oriented').

Since city mayors in Indonesia are directly elected by the city's voters, they presumably have a strong incentive to try and fulfill the aspirations of their constituencies through higher investment and growth. One way to achieve this is to facilitate private investment through complementary public expenditures. But political factors may also influence the extent to which the government focuses on investment facilitation. In particular, local leaders wish to stay in office and, where possible, rise in the political hierarchy. Doing so requires money which can most easily be obtained either from extractions associated with the implementation of government policy, or from direct payments from the private sector. Thus the 'optimal' choice of public spending priorities may be distorted by the need to raise campaign funding. Similarly the 'optimal' choice of private sector investments to support may be distorted by the potential financial gains to be gleaned from such support. We would therefore expect a more 'rent-seeking' local investment climate in situations where there is a strong need for political campaign funds, where the mayor's political advancement in the party depends more on financial contributions than good local economic performance and where the probability of being caught for corruption is low and the associated sanctions weak.

The second dimension assesses whether the government facilitates investment impartially in a manner accessible to all ('inclusive'), or whether it facilitates access only to a few key investors close to the government ('exclusive'). Local leaders are likely to take a more 'exclusive' approach if there are only a handful of large potential investments, because it makes sense for the leader to ensure the success of these investments rather than attempt to reduce costs for myriad local businesses with low investment potential. Moreover, the key concern for such large investors is not generally the overall cost of doing business, but avoiding the risk of 'hold up' after they have committed resources to the project. In the absence of a strong legal system, this generally requires personal guarantees from local leaders. On the other hand, if the aggregate size of potential small-scale investments is larger than the total size of the large specific investments, then we would expect that the focus would be on improving the investment climate for all. For example, we might expect that leaders in poorer or natural resource rich regions with few investment opportunities will focus more on trying to facilitating specific relatively large investments, whilst leaders in richer regions may focus on more systemic improvements in the investment climate. Technical skill may also affect the inclusiveness of the investment climate. Where bureaucratic reform is difficult (e.g. because of institutionalised corruption) and the executives' skills are weak, they are more likely to focus on exclusive relationships with a handful of key business players.

The third dimension we explore is whether developments are part of a plan put together by the local government for the development of the city – or whether they occur in a more arbitrary and unplanned fashion. Again there is no presumption that either approach will give rise to more or better investment. However, it is useful to identify whether investment performance appears to be identified with more or less planning and the way in which the planning process and associated regulations influence the decisions to invest.

The literature points to three aspects of the political and institutional context which may shape the nature of the local investment climate:[4] sub-national competition (e.g. Weingast 1995; Besley and Case 1995); collective action and interest groups (e.g. Becker 1983; Grossman and Helpman 1994); and the quality of leadership (e.g. Williamson 1994; Grindle and Thomas 1991; Gray and McPherson 2001).

Each of these factors can influence each of our three dimensions of the investment climate. For example, sub-national competition for investment might reduce the extent of rent-seeking due to the mobility of capital; equally local actors may be able to put pressure on a local government to be more inclusive, by publicising the good examples of neighbouring districts. Similarly, different types of collective action by interest groups will have different effects on the dimensions of the investment climate. For example, broad-based collective action by the private sector may be able to encourage more inclusive policymaking. But often local business groups have few incentives to engage in such collective action: local business elites fare better through their personalised contacts with senior government figures, whilst smaller firms fail to organise themselves due to coordination and free-rider problems. It is therefore important to assess the extent and nature of collective action or interest-group activities taking place and to identify whose agendas they serve. Moreover, there may be exogenous factors which condition the nature of collective action. For example, districts with only a few key resources are more likely to be susceptible to narrow interest group politics than regions with a broader-based economy and a range of economic actors (Moore 2004).

Leadership will also play a key role in determining the nature of the local investment climate (von Luebke 2007). But explaining the nature of the investment climate merely in terms of the quality of leadership is unsatisfactory since it does not answer ‘why one region got a good leader and another region did not’. Hence, it is necessary to probe the incentives faced both by prospective candidates and political parties in order to gain a better sense of why good candidates are selected in some cases but not in others.

Beside these three factors, national level regulations and requirements may provide incentives to the key local actors to behave in ways which are more or less oriented towards investment. Similarly political ties between local and national leaders may have an important influence on the way in which the local investment climate is designed. And local institutional capacity may influence the way in which the local government attempts to provide services to investors.

5 Methodology

To explore the questions posed above we undertook detailed qualitative fieldwork in two cities: Manado in North Sulawesi, and Solo in Central Java. These cities were picked for two reasons. First they are roughly of the same size, both in population and the size of their economy, so that, *a priori*, we would expect investment climate issues to have similar importance in both places. Second, anecdotal information from donor projects suggested that the quality of local governance was very different in the two locations. By purposively selecting

4 Of course this list is not exhaustive. There are potentially many other determinants of the character of the local investment climate, but we focus on the three aspects that are most prominent in the literature.

locations which were broadly similar economically, but different in the governance dimension, we hoped to be able to examine the impact of governance on economic performance. Specifically, we wished to see whether locations in which good local governance has produced a better investment climate for all firms attract more investment than locations where the general investment climate is poor and investment is driven more by personal connections between large private and public actors.[5]

The fieldwork in Manado was conducted in November 2007 and that in Solo in February 2008. More than 20 in-depth interviews were conducted in each city with local firms (both large and small), media representatives, NGOs, a range of government bureaucrats, the government leaders (the Deputy Mayor in Manado and the Mayor in Solo), and parliamentarians. This was complemented by three additional sources of information: first, we conducted a survey of around 50 local small and medium enterprises (SMEs) in Manado and 60 in Solo (across key economic sectors) in order to quantify local perceptions on the investment climate; second, we invited a number of small and medium sized firms to a focus group discussion to discuss the determinants of the local investment in greater depth; and third, we compiled and analysed a range of secondary data sources including government regulations, public budgets, credit statistics and newspaper clippings, to triangulate the evidence emerging from the interview data.[6]

Manado, the capital city of the province of North Sulawesi, had a population of 417,700 people in 2006 and a GDP of US$ 1,316 per capita in 2005. Located on the shoreline, Manado has become a growing tourist destination because of its proximity to the Bunaken National Marine Park, an area of international importance for its marine ecosystem. In 2005 it had almost 300,000 tourist visitors, a figure which has been increasing by almost 20 per cent a year since 2002. Manado's economy also benefits from having the province's main airport close to the city with daily direct flights to Indonesia's capital, Jakarta, as well as to Singapore, and, as the capital city of North Sulawesi, Manado has better infrastructure and more modern financial services than other towns in the province. The economy of Manado is dominated by the tertiary sector, with the Trade, Hotel and Restaurant sector contributing 26.1 per cent of GDP and the Services sector 23 per cent. The Trade, Hotel and Restaurant sector also employs the largest number of people (around 30 per cent of employment) and almost all of the outstanding investment loans in mid 2007 were in the Service (48.9 per cent) and Trade sectors (44.5 per cent).

The city of Solo is the second largest municipality in Central Java, located in the eastern lowlands between two volcanic mountains. While official statistics report a population of 550,000, daytime numbers can rise up to 1.5 million, owing to the large inflow of commuters from surrounding districts. The city of Solo developed around an ancient Javanese kingdom – the *Keraton Kasunanan*. This historical

5 The selection was also driven by practical considerations: the authors had local contacts in the two cities who could help with data issues and access to high-level policymakers.

6 In the case of Manado we also made use of an existing survey of small firms focusing on licensing issues that was provided by Lembaga Pengembangan Teknologi Pedesaan (LPTP).

heritage features prominently in today's sultanate palace (*Sangga Buana*), which has become one of Solo's main tourist attractions. The economy of Solo primarily rests on secondary and tertiary sectors. In 2007, Solo's GDP accrued mostly from trade, hotel and restaurant services (24.2 per cent), local manufacturing (24.1 per cent), and physical construction projects (13.4 per cent).

To assess the impact of the investment climate on economic performance in each city, we collected the available statistical data, including GDP figures and outstanding investment loans at local banks. These quantitative indicators were then complemented with the interview data from local firms, academics, NGOs and journalists. In particular, respondents were asked to describe their perceptions about the key factors driving local investment.

After estimating economic performance, we then analysed the local investment climate itself. Aspects like the time and cost of obtaining licenses, the access to business opportunities, and the availability of business-relevant public services, were assessed by combining the results of the business survey and the in-depth interviews. Assessing these different aspects of the investment climate gave an indication of the extent to which the climate could be characterised as investment oriented or rent-seeking, inclusive or exclusive, and planned or unplanned. Appendix 1 shows some of the indicators used to assess the underlying characteristics of the investment climate.

6 Characterising the investment climates of Manado and Solo

6.1 Rent-seeking vs investment facilitation

The regulatory environment in the city of Manado is complex and confusing. The local government has enacted a set of local laws (*perda*) that exact imprudent user charges (*retribusi*). The legal justification for many of these user charges is unclear, often due to poor coordination between local and national governments. Much of the work of the local parliament is taken up in amending local regulations to fit with national laws and decrees. However, the chair of the Economic and Finance Commission of the local parliament acknowledged that his institution has difficulty in keeping up with these frequent changes. A number of respondents claimed that the resulting confusion regarding the legal status of various charges provides room for rent-seeking.

Getting business licenses in Manado is also cumbersome and time-consuming. Evidence for this can be found in a survey of 52 micro and small businesses in the trade, hotel, restaurant and services sector in Manado who were asked about their experience of obtaining common business licenses (LPTP 2007). More than three-quarters of these firms did not have any formal legal status. However, all of them had business registration and trade licenses and almost all had at least three other common licenses. The principal reason given for obtaining these licenses was to avoid fines and legal and illegal exactions. Interestingly, almost no respondents stated that the licenses helped them to get access to credit or local markets which is the theoretical purpose of the license.

Moreover, less than a fifth of respondents actually processed the licenses themselves, with the majority preferring to use informal intermediaries. In most cases these intermediaries are government officials acting outside their normal duties. There is therefore clear evidence that licensing in Manado is complex and time-consuming, not because this serves any social good, but because it gives opportunities for government officials to earn additional rents from helping businesses navigate their way through the process.

The focus group discussion and our own survey revealed similar findings. The majority of respondents found it difficult to access information about licensing. Similarly, the bulk of local firms felt that license procedures involve a substantial amount of administrative red tape whilst more than 80 per cent of the survey respondents regard the current licensing practices in Manado as corrupt (Table 6.1).[7]

Table 6.1 Comparison of business perceptions of the investment climate in Manado and Solo

	Manado	**Solo**
Licensing		
% saying difficult to access information	61	41
% saying process is complex	61	39
% saying process is corrupt	82	62
Tender Process		
% saying difficult to access information	82	84
% saying process is complex	94	90
% saying process is corrupt	92	85

Note: The sample consisted of 51 randomly selected SMESs in Manado and 64 randomly selected SMEs in Solo. The questions were framed in Likert scales with 4 points e.g. ‘Access to information’ ranges from ‘very easy’ (1) to ‘very difficult’ (4). Figures show the percentage scoring 3 or 4 for each characteristic.

7 It would, of course, be preferable to have actual data on levels of corruption. However, collecting such data is difficult because respondents typically do not want to admit giving or receiving corrupt payments. We therefore rely on respondents’ perceptions about the levels of corruption in different processes.

To tackle problems of rent-seeking in licensing, several districts and cities in Indonesia have implemented One Stop Shops (OSS) for business licensing. However, most respondents claimed that the OSS in Manado is not yet functioning well. Several respondents expressed frustration that OSS services are much better in some of the neighbouring districts in North Sulawesi. Respondents from the city government admitted that one reason why Manado's OSS is not progressing well is because there are conflicting interests across individual offices under the city government with each office reluctant to give up its source of license revenue.

Looking at tendering, it is illegal for government officials to grant a contract with a value more than Rp 100 million to a third party without an open tender. Similarly, parliament members are not allowed to become contractors for government projects. However, according to several respondents (including some government officials and parliamentarians), these rules are often violated in practice. Almost all key business players agreed that tenders with government projects can still be manipulated in favour of individuals or groups close to the government. The perception that public tender procedures continue to be skewed towards the powerful few receives strong support in our local business survey with over 90 per cent saying that the process is complex and corrupt (Table 6.1).[8]

Rent-seeking also appears in the provision of public services in Manado. Often business people will refrain from complaining about public services or facilities because doing so results in visits by the police, members of parliament, and even NGOs – each offering to solve the problem in return for a 'voluntary payment'. Even when businesses do not complain they are often visited by officials seeking illegitimate payments.

The evidence above suggests that rent-seeking by the local government bureaucracy is commonplace in Manado. Certainly this is the view of most SMEs – 37 out of the 51 SMEs surveyed thought of the government's attitude as being biased towards 'its own interest' as opposed to 'promoting a better investment climate'. However, this generalised extraction sits side by side with the pro-investment views of the executive. For example, the directly elected vice-mayor was strongly of the view that all efforts should be made to attract investors and several business respondents agreed that the mayor made efforts to attract investors and to push for public infrastructure investments to accelerate local growth. There would therefore appear to be a disconnect between the views of the top level officials and the bureaucracy underneath them, or, at least, an inability to change the administrative systems and incentives faced by local level bureaucrats to ensure that they implement the mayor's pro-investment vision.[9]

8 Several respondents said that there has been an improvement over the last few years, in part due to the national campaign for transparency and accountability, as well as strict monitoring from institutions such as the Komisi Pemberantasan Korupsi (KPK) [Corruption Eradication Committee] and the, Badan Pemeriksa Keuangan (BPK) [Supreme Audit Agency]. But many also claimed that this improved transparency has come at the cost of slower administration for government contracts.

9 For more detail see McCulloch *et al.* (2009).

The situation in Solo is rather different. Solo's regulatory environment, for example, appears less problematic than that of Manado. An independent assessment of the quality of local regulations in 2004 evaluated Solo's local bills as 'fairly conducive' for investment with no serious obstructions to local trade or investment activities (KPPOD 2004).

Similarly, most respondents in Solo say that business license administration has become more business-friendly over the last two years. Responding to complaints of the business community, which repeatedly criticised the myriad of administrative desks and paperwork, the mayor of Solo, Joko Widodo 'Jokowi' has streamlined existing licensing procedures through the establishment of an effective 'One-Stop Shop' (OSS). The Head of the OSS explained that the reform initiative was inspired by Jokowi's prior business experience as a furniture exporter.

The process whereby the mayor achieved this reform is also revealing. He first gathered support in the local parliament and then approached technical departments. Since regulatory processes in the parliament take time, the mayor issued a preliminary executive decree to authorise the establishment of the OSS. This move was popular with businesses, but evoked mixed reactions among some bureaucrats, particularly where the creation of the OSS has stripped their department of valuable income sources. Table 6.1 shows that business perceptions of the ease of access to licensing information and the simplicity of the procedures are substantially better than those in Manado. However, more than 60 per cent of respondents still reported that they have experienced substantial irregularities while obtaining standard business permits. Interestingly, firms reporting higher corruption problems were also those with less access to licensing information. Since the OSS provides firms with ample information, this suggests that irregularities may be the result of firms dealing directly with departmental agents instead of going to the OSS.

Despite this, reforms do not appear to have taken place in all areas. For example, more than 80 per cent of respondents in Solo's business survey said that the tendering process was opaque, complex and corrupt, little different from the figures obtained in Manado. Nonetheless, the qualitative impression of the business community in Solo regarding the local government is much more positive than that in Manado. This is also reflected in our surveys with around half of our respondents stating that Solo's government has an investment orientation compared to little more than a quarter in Manado.

6.2 Inclusive vs exclusive relations

The evidence regarding the inclusiveness of economic policymaking in Manado is mixed. On the one hand, members and leaders of SME associations claimed that they had a close relationship with government officials, particularly with those from the Local Office for Cooperatives. Members were invited to discuss issues with the government several times every year and were informed in advance of activities and programmes from which they might benefit. On the other hand, larger businesses almost uniformly claim that the government never consults them on economic policies until after these policies have already been put into place. In part, this is because larger businesses tend to detach themselves from the government which they regard more as an obstacle to getting things done than a help. This ‘self-exclusion’, which is done to avoid hassle and potential exaction, also may result in them not being consulted or involved in policy developments that do occur.

Unsurprisingly, almost all government departments claimed that they sought the views of the private sector and the broader community on policy issues. Bank Indonesia in North Sulawesi, for example, has been involved in a number of initiatives both to seek the views of the private sector and to act as an independent actor to coordinate the actions of different parts of local government. Similarly, Kawasan Pengembangan Ekonomi Terpadu (KAPET), the ‘integrated economic development zone’ responsible for providing fiscal incentives to potential investors at the provincial level, clearly has a proactive approach to involving the private sector. The same is true for some elements of Manado city government. For example, the city administration department that approves building licenses stressed its proactive efforts to ensure that the conditions, fees and processes required are widely disseminated and the legal department was able to quickly supply books of all the local regulations, including a compilation of all local user charges.[10]

However, for the most part, government departments appear to go through rather ‘pro forma’ consultation with a small number of familiar contacts once or twice a year. Some claimed to involve the private sector through their inclusion of KADIN, the local chamber of commerce, despite the fact that almost all private sector respondents agreed that KADIN is more or less moribund in Manado. In summary, it would appear that the city government does make some effects at the dissemination of existing policies and information, but there seems to be no serious attempt to involve the private sector more systematically in the policy-making process.

The other aspect of inclusion or exclusion is the extent to which businesses have equal access to new business opportunities. Here a very clear picture emerged: large businesses that are well connected with the government, particularly through party contacts, receive preferential treatment relative to smaller and less well connected business people. The top government officials are clearly keen to attract investors. However, only a handful of business people have direct access to the provincial governor or mayor. These key business players usually contact the top executives if they face problems. Those with smaller businesses have to deal with lower level officials and frequently become objects of harassment. For example, there were only a handful of businessmen involved in the reclamation of Manado bay. They include: a large Manadoese investor who used to be a Golkar national member of parliament and is close both to the former mayor and the former governor; a local Chinese Indonesian tycoon who is close to a leading

10 At the same time, the focus of the legal department was only on ensuring the distribution of these books to the various different levels of local government – they were not available on a website, shop or information centre of any kind.

national politician and former General and to another leading national politician who leads a mass-based Muslim organisation; and an investor originally from Makassar (South Sulawesi) with connections to senior national politicians in Partai Demokrasi Indonesia Perjuangan (PDIP), the largest opposition party. Only a handful of people are considered to be the main actors in the economy of Manado and the surrounding area. When asked who the top businessmen were in the city, almost all respondents came up with the same very shortlist of names.

As an illustration of the special position held by a small number of large investors, several respondents pointed to the case of a hotel where the investor cleared the development directly with the mayor first and was told explicitly to go ahead and sort out all the permissions and licenses later. When a lower level official responsible for issuing the licenses asked what he should do he was told to ‘use his discretion’, a clear signal to turn a blind eye to the lack of a license.

This ‘personal approach’ was regarded as a positive thing by most senior government officials, who saw it as a means of facilitating and attracting large investors given a complex licensing environment. The strong personal connections between large businessmen and the executive do not only benefit the entrepreneurs. One large local businessman acknowledged that he provided financial support to the former mayor’s campaign and was also on the campaign team for the former governor.

It would be interesting to know more about the basis for the relationships between the handful of large well-connected business people and the executive in Manado, i.e. whether they are primarily based on party affiliation, region, ethnicity, religion, or simply mutual financial interests. Unfortunately, the rather secretive nature of these relationships in Manado made it extremely difficult to assess this in any depth. Only one of the top five businessmen agreed to be interviewed and the mayor also refused an interview (although we interviewed the deputy). Other respondents suggested that linkages were driven by a mixture of political party affiliation, preferences for locals, and mutual financial gain, but, beyond this, we have no strong evidence about the basis of the relationships between these key actors.

Similarly, we have relatively little information on whether, unlike other large businessmen, these few key businesspeople are consulted on policy or not. The overall impression given by our respondents is that the frequent interactions and close connections between these key actors and the executive mean that they are aware (and have an input into) any major developments that affect their business interests, and may also be informally consulted on other issues of city development (e.g. the relocation of street traders). However, the focus of their interaction would appear to be on facilitating business opportunities rather than broader policy concerns.

Generally, small businesses do not have access to the same channels of influence and therefore have to go through the time-consuming and bureaucratic procedures laid down under the local regulations. Although there may be some niches of influence for a few small firms, the respondents at the focus group discussion of small businesses confirmed the general picture that policy is applied in a discriminatory and somewhat exclusionary fashion, with small businesses forced to comply with a complex, corrupt and unclear regulatory environment, whilst larger investors used personal contacts to minimise the burden that they face. Our own survey confirmed this with four out of five of the respondents saying that the government tended to discriminate in favour of some businesses rather than treating all businesses equally.

The situation in Solo appears to be very different from that in Manado. The findings from our business survey indicate the presence of a wide and evenly spread range of business associations – comprising multi-sectoral/scale/ethnic interests. Nine influential organisations are recognised as 'key business associations' by at least a quarter of the survey respondents.[11] The composition of these business associations reveals a wealth of sectoral interests – including public construction, furniture, real estate, hotels and restaurants, land transportation and handicraft. The results also signal a range of ethnic influence.[12]

Based on focus group discussions with local firms it became obvious that Solo's business associations are not concentrated, but remain in notable distance to each other. Although some groups are somewhat closer to the mayor than others, the discussions with local firms confirmed that there is considerable competition between sectoral associations. Overall, the multisectoral character of Solo's economy and the balanced influence from Chinese and Javanese firms render the emergence of narrowly defined collusion arrangements improbable. As soon as one group receives illegitimate benefits from the government, another equally influential group is likely to intervene. The inclusiveness of Solo's policy sphere has also benefited from the leadership of Mayor Jokowi. Business respondents unanimously agree that the mayor's open-house policy has created a valuable communication platform for a wide spectrum of private sector interests. Although these face-to-face consultations in the mayoral residence are mostly informal, they are not skewed towards any particular interest groups. From time to time, these informal channels are complemented with official forums, such as Solo's 'coffee mornings', a bi-monthly event that brings together public and private actors to exchange their thoughts.

Overall, it seems that Solo's mayor has been successful in striking the right balance between diverging religious and ethnic fractions. On the one hand, he maintains close ties to Javanese Muslim communities. He also reaches out to the wider Javanese society by attending local 'mutual help' associations (*arisan*) in Solo's suburbs. The business voices that emerge in these meetings, the mayor explained, are primarily those of small traditional firms which are concerned about

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11 These are associations of businessmen in public construction (GAPENSI), industry and commerce (KADIN), furniture export (ASMINDO), real estate (REI), hotel and restaurants (PHRI), land transportation (ORGANDA), handicraft (ASEPHI), and the association of young entrepreneurs (HIPMI) and Chinese entrepreneurs (PMS).

12 According to our observations, ASMINDO, ORGANDA and ASEPHI display a high membership of Javanese firms, whereas REI, PHRI and PMS are strongly influenced by Chinese business interests. Moreover, while some organisations are dominated by concerns of large firms (GAPENSI, REI, PHRI, and PMS), others also exhibit a strong link to small-scale business interests (ORGANDA, ASMINDO and ASEPHI).

licensing services and microcredits. On the other hand, there are equally strong links between the government leadership and the Chinese community. Thus, contrary to the Suharto era, where government-business interaction were often biased and remained behind closed doors (Root 1996), today's informal relationships in Solo are more balanced and transparent.

The Jokowi administration also demonstrates inclusiveness in terms of its support towards different business sectors. The government's assistance to two sectoral groups – street vendors and real estate developers – provides an illustrative example in this context. Solo's far-reaching street vendor programme has been widely reported throughout Indonesia.[13] Since 2006, Solo's government has been gradually providing sheltered market spaces and microcredit to over 5000 roving street vendors, Pedagang Kali Lima (PKL). To achieve this, Mayor Jokowi has entered into numerous lengthy negotiations with the PKL associations over the last two years, to facilitate the relocation. Most observers agree that the relocation programme has brought several benefits for Solo's economy.

Perhaps most significantly, supporting street vendors and traditional businesses has opened the door for three large new real estate investments. This is because, when Jokowi gave his permission for real estate development, resistance was low because the support for PKL and traditional markets was still fresh in people's memory. The fact that these developments went ahead is indicative of the good relationships between the mayor and key large businessmen in the real estate and hotel sectors whose investments far outweigh those of the traditional sector. However, unlike Solo, respondents did not identify a small number of key private sector actors with exclusive access, but rather his skill in balancing the economic interests of different groups. This was confirmed in an interview with the mayor in which he stated: 'my objective is to create a modern city that maintains its heritage… it is important to strengthen traditional businesses and markets… but, at the same time, Solo is changing. It needs to accommodate new investments and urban development.' Overall, the nature of public private interaction in Solo appears to be much more inclusive than in Manado. This is borne out by our survey with twice as many businesses in Solo saying that the mayor treats all businesses equally than in Manado.

6.3 Planned vs unplanned development

Manado's government officials claimed that they had a master plan that also covers city planning.[14] However, the evidence from the interviews suggests that the economic progress which has taken place has had more to do with initiatives from the private sector rather than a well-coordinated plan from the government. The first phase of reclamation of Manado bay in 1995 was not part of any government masterplan, it was purely a private sector initiative. The memorandum of understanding between the investor and the government stated that all funding would

13 See e.g. *Kompas* daily 17 March 2006 and *Kompas Yogyakarta* daily, 1 March 2008.

14 This is the RPJMD 2005–2010. The legal document for this is Perda 4/2005.

come from the investor and in return the government would be given 16 per cent of the land.[15] The subsequent phases of reclamation were also not laid out in any government plan. In fact the local law for city planning expired in 2000. A new plan has been drafted and reportedly will be reviewed by the DPRD 'sometime soon'. However, a leading parliamentarian said that there were 16 bills under review, but the city planning bill was not one of them.

The lack of coordinated planning on the part of government is compensated to some extent by an active regional office of Bank Indonesia (BI). BI frequently facilitates fora for communication between government, parliament and business representatives. According to the head of BI's provincial office, such fora can be useful for communicating the government's plans to businesses. However, the topics discussed are usually not related to the legal planning documents such as the medium term development plan. Rather, most of the 'plans' are one-off in nature such as the planning for the World Ocean Conference in 2009 (which is in line with Manado's vision to become World Tourism City by 2010) or are laid out by higher levels of government or agencies can cover a broader region such as the office of the integrated economic development zone (KAPET). As a result, it is not clear whether the government has preferences as to where and in what sectors investment should be encouraged. A parliament member reported that the government has designated the northern part of the city to become a 'Kasiba' (*kawasan siap bangun* – ready-to-build area), but again it is not at all clear how this will be implemented and officials from the City Planning Office were not able to provide a clear answer.

In sharp contrast, Solo seems well planned. Solo's development plan follows the maxim 'tradition meets modernity'. It is evident from interviews that Solo's development plan is the result of interactive process thanks to the high level of inclusiveness in its policymaking process. Business (and other) actors can express their interests and concerns by consulting with the mayor and, to a limited extent, by participating in council hearings. The reformist orientation of the mayor and the broad spread of private sector interests appears to provide a good platform for investment-oriented planning. Almost 70 per cent of the businesses in our survey felt that the government's activities are well planned.

The balanced government treatment of traditional and modern businesses (street vendors and real estate developers) in Solo also extends to its upcoming development priorities. A clear example in this context is the plan to strengthen small-scale business and tourism by revitalising some of Solo's historical city areas including the traditional market area *'Pasar Klewer'*, the old batik quarter *'Laweyan'*, and the sultanate palace (*Sangga Buana*). At the same time, Solo's urban planning places great weight on modernisation. The government has advanced a plan to establish an innovative technology centre (*Solo Techno Park*). The foundation stone of the centre was laid in 2007. The next steps will be to establish vocational training facilities and a business incubator with the co-funding of a European investor. The local government is also planning to sign an agreement with the 'Cambridge School' in Singapore to enhance secondary and tertiary education in Solo.

15 Four MOUs were signed between the developers and the mayor in 1995.

Solo's government is also planning to take advantage of national government programmes to make Solo a more appealing location for future investment. Probably the most important stimulus will be the construction of two interprovincial highways which will intersect at the city's northern boundaries. Although these toll road projects are managed in Jakarta, the mayor indicated that his lobbying of central government may have helped to speed up their implementation. Similarly, the planned extension of Solo's regional airport will attract larger carriers and may help to boost tourism. It is also hoped that visitors and investment opportunities will result from a series of national and international events due to take place in Solo including a UN Habitat event, a national food fair, and the annual meeting of Indonesian municipalities.

7 The political economy determinants of the investment climate

The section above characterised the investment climate in Manado and Solo. This section examines the underlying political economy factors that may explain the different investment climates observed.

7.1 Sub-national and political competition

The literature on sub-national competition suggests two forces which can counter-balance the tendency of public administrations to obstruct private economic activities: economic checks in terms of inter-jurisdictional asset mobility, and political checks in terms of electoral pressure. Given the characterisation of Manado's investment climate above, one might expect to observe significant out-migration by both firms and workers. In fact, the reverse appears to be true. Several respondents said that in-migration from surrounding areas was contributing to local economic growth. Such in-migration was primarily caused by conflicts in neighbouring regions. Almost all respondents regarded the relative peacefulness of Manado as one of the strongest aspects of its investment climate. Given its peacefulness and its position as the capital of the province, it seems unlikely that inter-juristictional mobility acts as a significant constraint on the actions of Manado's government.

Economic accountability checks also appear to play very little role in Solo. Many of Solo's business people are tied to their current location because of relatively immobile assets and established customer networks. Furthermore, Chinese business people, who constitute a large economic force in the region, refrain from moving out of their familiar environment, as this may expose them to more ethnic or religious frictions. Solo is renowned for its inter-ethnic conflicts. A series of clashes between indigenous and non-indigenous groups in 1965, 1980 and 1998, resulted in severe casualties and property losses in the Chinese Indonesian community. In order to prevent future hostilities, Chinese firms have invested in a wide range of community facilities, including a professional sports centre, a stand-by ambulance, and mobile fire-fighting appliances. Moving into a new district would render these precautionary investments ineffective.

In contrast, political checks may be more effective in the long-run at restraining local government exaction in both Solo and Manado. The introduction of direct elections in 2004 provides local government heads with strong incentives to attend to the voices of their constituencies. Poor performance, including rent-seeking by their administration or the failure to attract investment, can lead to electoral failure. This accountability link is strengthened by the emergence of yardstick competition. In Solo several respondents were aware of the performance of district heads in neighbouring regions. The district head in Sragen, for instance, is often quoted as a reformist leader that sets comparable benchmarks of government reform. Thus, Jokowi's political success depends on the degree to which he keeps his performance in line with regional yardsticks. The same is true in Manado, where a number of respondents compared the poor quality of public administration services in Manado, particularly for business licenses and permits, with much better services in the neighbouring districts of Minahasa and Tomohon. This may exert political pressure upon the mayor to improve Manado's performance.

The need for campaign funding may also act as a restraint on the actions of the mayors. According to a senior public official in Solo, if the mayor Jokowi wants to stay in office, he will require additional campaign funding and political support from the private sector. This provides an incentive for him to continue to pursue improvements to the investment climate. In Manado, the exclusive nature of the public-private relationships may weaken this pressure. However, one respondent did state that he would be supporting the candidates in proportion to their probability of winning. If other funders take a similar view, then access to campaign funding may depend upon more general improvements in the investment climate in Manado.

7.2 Interest group constellations

Pressure from formal business interest-groups seems to have little influence in Manado because there are only a handful of key businessmen that run the economy. Furthermore, these key players act individually. They do not use channels such as the Chamber of Commerce (KADIN) to voice their concerns. In fact business associations appear to be almost irrelevant to policymaking in Manado, with almost all private sector respondents agreeing that KADIN plays no useful role in Manado.

However, party affiliations do appear to affect the behaviour of the executive. For example, one large local developer close to the former mayor received a license for a major land reclamation project. But, when he subsequently switched political party from Golkar (the party of the current mayor) to Partai Demokrat (the party of the current President), his license was revoked by the new mayor. The origin of the investor also seems to matter. For example, when one piece of reclamation land was disputed by two investors, the government made a decision in favour of the local investor and against the investor from Makassar.

In the case of Solo, business interest groups do appear to play an important role in shaping the direction of public policy. As noted above, Solo's private sector exhibits a large array of sectoral business associations. The inclusive approach of the current mayor seems to have provided these associations with a flexible and effective way to voice policy concerns. At the same time, the fact that there are so many competing interests in Solo provides the mayor with an incentive to pursue reforms which will be in the wider interest, rather than those which might benefit one group at the expense of another.

7.3 Leadership

Leadership can play a significant role in determining the character of the investment climate. We briefly review the backgrounds of the leaders in both cities and discuss how this may have influenced the character of the investment climate observed.

The mayor of Manado, Jimmy Rogi and his vice mayor, Abdi Buchari, were elected in 2005. Mayor Rogi comes from a poor family. In his youth he was first a rickshaw driver, then a public minibus driver, a truck driver and a taxi driver. He also once worked as crew on a ship. He joined the biggest political party in Soeharto's era, Golkar, and over several years climbed the political ladder to become the chairman of Golkar in Manado. He then became the head of North Sulawesi's House of Representatives. He is reportedly close to the current national Golkar chairman, Jusuf Kalla, who is also the vice president of the Republic of Indonesia, as well as to the current Golkar deputy chairman Agung Laksono, who is also head of the Indonesian House of Representatives. Despite his high level contacts, several respondents commented that the mayor is not a very sociable person. He is described as a career politician with no particular skills in bureaucratic reform or policy communication and therefore reluctant to deal directly with the public at large.

The nature of the investment climate in Manado is consistent with the background and skills of the mayor. Our conceptual framework led us to expect that rent-seeking would be higher in locations where there is a greater need for campaign funding and where political advancement depends upon securing such resources. As a career Golkar politician with no independent source of wealth, the mayor is likely to have to rely on contributions from a small number of wealthy business people. Moreover, political advancement in the Suharto era depended on associations with well connected individuals rather than popular appeal. The background and experience of the mayor therefore makes it more likely that he would engage in exclusive relationships with a few large businessmen rather than attempt bureaucratic reforms to improve the investment climate for all.

In contrast to Manado's mayor, Solo's Jokowi is much more accessible. A large number of interviewees, both in the private and public sector, stressed that Solo's first directly-elected mayor has been an important driving force for Solo's economic development. According to the respondents, Mayor Jokowi has initiated policy reforms that make Solo's neighbourhood safer and its bureaucracy more efficient. Since his election in June 2005, illegal extractions by local hoodlums and the frequency of violent demonstrations in Solo have decreased significantly. The reason for this improvement is the mayor's continuous efforts to tackle problems in Solo's suburbs by directly approaching people and their problems. Moreover, Jokowi's extensive business experience (he was a successful furniture exporter) has been a valuable asset in his attempts to increase the performance of Solo's bureaucracy. His background in business has given him strong managerial skills which have proved useful in undertaking public sector reforms. A few respondents also pointed out that, because he is already wealthy, he is less susceptible to corruption.

The influence of the mayor's managerial skills is also illustrated by his efforts to create a strong performance culture within the civil service and reduce administrative corruption and inefficiency. Jokowi is known to drop in unexpectedly to departments to assess their performance. He has also signaled that he is prepared to penalise administrative misbehaviour. He holds monthly evaluation meetings to assess performance and has disclosed his mobile phone number for 24-hour public complaints, thereby putting pressure on high-ranking officials to perform. Two former officials who stood in the way of his OSS reforms were removed from their positions.

In light of his reform efforts, financial independence, and extensive business experience, it is clear that the leadership of Solo's current mayor has had an important influence on the character of Solo's investment climate. What is less clear is whether these reforms would be sustained if Jokowi were no longer the mayor.

8 Economic performance

Having outlined the character of the investment climate in both cities, and the political and institutional factors that may have given rise to the environment observed, this section explores the actual performance of Manado's and Solo's economies in recent years. Attributing economic progress to the characteristics of the cities' investment climate is a difficult endeavour. Two attribution problems in particular deserve attention. First, improved local economic policies are by no means the only factor that drives growth and investment. There is a rich empirical literature that demonstrates that (especially long-term) economic progress is explained by differences in geography, factor endowments, historical heritage and institutional architectures. These exogenous factors and other nationwide determinants (such as changes in consumption patterns, credit lines, or macroeconomic policies) cannot be controlled for in our case-study approach. Second, improved investment conditions and observable investment realisations are likely to be separated by a time lag. This renders the attribution less certain: as most of Manado's and Solo's economic indicators are available up to the year 2006, roughly one year after the mayors' administration took office, causal links need to be made with caution.

8.1 Manado

The performance of Manado's economy has been improving over the last five years. Real GDP grew on average by 2.1 per cent per year between 2001 and 2005, but, in keeping with the national trend, growth has picked up in the last couple of years and was 5.1 per cent in 2006. The GDP growth was fastest in the trade, hotel and restaurant, and construction sectors. This is reflected in the highly visible boom in construction that was taking place in the city during the period of the fieldwork. Much of this is driven by a major set of mall developments on land reclaimed beside Manado's main coastal road. In addition, a number of large new hotels have been constructed over the last few years.

This impressive progress is also reflected in the investment data (Table 8.1). Outstanding investment loans in North Sulawesi grew on average by 28 per cent per year between 2003 and 2006, with 78 per cent of the outstanding loans being made in Manado (Bank Indonesia 2007). Outstanding loans for investment grew faster than lending for consumption or working capital. The bulk of outstanding loans are for trade and services (particularly transportation and business services). Outstanding investment loans for trade grew by 85 per cent per year between 2003–2006, with rapid growth also recorded for business services (57 per cent) and construction (17 per cent).[16]

Table 8.1 Outstanding investment loans: Manado

	Outstanding Investment Loans (Rp million) End 2006	Annual average growth (2003–2006)
North Sulawesi	745,697	28.0%
MSME	366,212	37.6%
Non-MSME	379,485	20.4%
Manado	592,344	38.5%
MSME	238,982	53.6%
Non-MSME	353,362	31.1%

Source: Bank Indonesia (2007)

16 Outstanding loans for mining also grew strongly, but from a very low base. These reflect mining activities elsewhere in the province.

Micro, small and medium sized firms (MSMEs) also appear to have participated in the economic expansion. In both North Sulawesi as a whole and Manado in particular, the growth of investment loans was faster for MSMEs than for larger firms. In Manado outstanding loans to MSMEs grew by 53.6 per cent per year between 2003 and 2006, although it should be noted that much of the lending to MSMEs was to medium-sized firms. Average annual growth of outstanding MSME credits in Manado was 35 per cent for medium-sized firms, but only 16 per cent for micro firms, with a similar pattern for North Sulawesi.

To get a sense of how much of this investment was being driven by exogenous factors, rather than local economic policy, our qualitative interviews asked respondents what they felt were the principle causes of Manado's recent growth. Most respondents mentioned the reclamation project and the property investments that have followed. As noted above, the reclamation of this land was entirely privately planned and funded. However, the close relationship between the investors and Manado's leaders may have facilitated obtaining the necessary permissions and the government was responsible for relocating the communities that previously used this stretch of land.

Other respondents said that the economy is booming due to the high rate of in-migration from areas near Manado which have recently experienced conflict, such as Ternate and Poso. According to several respondents, the immigrants have helped to boost the local economy since most of them of traders. Data from the national socioeconomic survey confirms that there was an increase of population between 1997–1999, which was the time of several conflicts in Eastern Indonesia.[17] In addition to a safe environment, respondents also mentioned better infrastructure (notably the airport) as well as access to business services such as banks and hotels as reasons for Manado's growth.

8.2 Solo

Investment flows in Solo have also increased significantly in recent years. According to Bank Indonesia, outstanding investment loans to MSMEs amounted to Rps 183 billion in 2006 and have grown by 9.5 per cent per year since 2003, while outstanding loans to large firms were Rps 157 billion and grew at an annual rate of 32.8 per cent during the same period (Table 8.2). Solo's MSME loans therefore expanded half as fast as the provincial average, whereas the growth of Non-MSME lending far exceeded the provincial average.

The fast growth of Non-MSME loans is consistent with the expansion of real estate and retail investments over the last few years. The ongoing constructions of three large apartment buildings – the 'Solo Paragon', 'Solo Center Point', and 'Kusuma Tower' – and the establishment of numerous shopping malls – including the 'Grand Mall', 'Solo Square' and 'Ciputra Sun Mall' – bear ample witness to these investment activities. Since Solo has limited land, private investments are

17 Subsequent slower increases in population may be driven by economic growth rather than causes of it.

expanding vertically – in real estate and modern retail – rather than horizontally in manufacturing industries. Moreover, some respondents claimed that high minimum-wages and rising labour standards have made Solo's manufacturing sectors less attractive to investors.

The expansion of Solo's private investment is not only determined by the improved investment climate. According to local business people, a set of external factors – including the future TransJava highways that will intersect near Solo – is having a strong influence on private sector decisions. At the same time, it is clear that the close public-private alignment between Mayor Jokowi and local firms has created a spirit of optimism and attracted both local and national investors. There is broad agreement among interviewees that the reduction of economic uncertainty – both in terms of improved security and reduced administrative preferentialism – has been a driver of business commitments. Thus, improved policy conditions are widely believed to have played a role in rising investment flows, even though the effect cannot be quantified.

Table 8.2 Outstanding investment loans: Solo

	Outstanding Investment Loans (Rp million) End 2006	Annual average growth (2003–2006)
Central Java	5,883,869	7.7%
MSME	2,791,908	18.1%
Non-MSME	3,091,961	0.8%
Solo	592,344	18.1%
MSME	238,982	9.5%
Non-MSME	353,362	32.8%

Source: Bank Indonesia (2007)

In summary, despite its poor general investment climate, investment in Manado grew rapidly during the three years prior to this study, while investment growth in Solo, with a good investment climate, appears to have been somewhat slower. Moreover, the data suggest that micro, small and medium sized enterprises have seen faster investment growth in Manado than in Solo – the opposite of what we might have expected given the more inclusive policies pursued in Solo.

Two caveats are in order. First, although our case study attempted to choose regions of roughly the same economic significance and potential, the provincial data suggest that investment grew much faster in North Sulawesi than in Central

Java during this period. This may reflect the different sectoral composition of their economies, with North Sulawesi more dependent on commodities which were experiencing rising prices during this period, whilst Central Java is more reliant on manufacturing. The stronger performance of North Sulawesi may be driving the stronger growth in associated secondary and tertiary activities based in Manado.

Second, although Bank Indonesia is the most reliable source of investment data at the regional level, these data are not without problems, especially at the city level. In particular, the fact that large firms do not always register their investments at the local level if the funds come from a Jakarta based firm, mean that the relative growth rates of MSME and non-MSME firms in both locations should be interpreted with some caution. In addition, outstanding loans is not the best measure of local investment since it reflects the net position i.e. existing loans plus new loans taken out minus repayment of previous loans. However, other data also support the general picture painted by the Bank Indonesia data. For example, a survey of firms at the district level undertaken in 2007 shows that sales in Manado increased by 30.9 per cent between 2006 and 2007, whereas sales of firms in Solo increased by only 8.7 per cent between these years (KPPOD 2008). Licensing data also support the general picture that investment boomed in both locations despite their very different investment climates (von Luebke, McCulloch and Patunru 2009).

9 Conclusions

Our case studies broadly confirm the idea that local policymaking influences investment primarily by reducing the risks faced by key large investors rather than reducing the costs of doing business for all. In both Manado and Solo, investment has boomed, facilitated in both cases by close personal relationships between the local leadership and key large investors in retail, hotels and property.

The success of Manado poses a particular challenge for traditional assumptions about the relationship between the investment climate and economic performance. Orthodox theory would suggest that environments which are characterised by high levels of rent-seeking, exclusive non-transparent personal relationships between key economic actors, and minimal public planning, should generally give rise to poor economic performance. Manado's success suggests that the level of investment depends a lot more on the government tackling specific risks for particular investments, rather than attempting to create an investment climate that is good for all.

It might be argued that Manado's success was in fact due to external factors, rather than local policy. Certainly the evidence from both cities suggests that there are a large number of external factors that can have a significant impact on local economic performance – our case study methodology cannot completely control for these. The fact that Indonesia as a whole was growing quickly during this period would lend support to the idea that both Manado and Solo's performance merely reflected the general health of the national economy, with a bias towards Manado because of the increase in commodity prices.

However, the qualitative evidence does not support such a simple conclusion. It is clear that the investments that took place in Manado did so because specific permissions were given, just as the improved sense of security amongst the private sector in Solo was the trigger for increased investment. It is therefore difficult to escape the conclusion that a key factor determining investment in these two locations was the personal and particularistic nature of the relationship between local leaders and key investors, rather than the generic quality of the broader investment climate. In short, it may not matter for aggregate investment whether the mayor's approach is inclusive or exclusive, at least in the short-term.

Even if such hand-in-hand relationships are sufficient for triggering investment, it may be the case that the 'Manado model' is not capable of sustaining such investment. The evidence from our case studies suggests that polities characterised by rent-seeking, exclusive relations and unplanned development may be less politically stable. Recent developments lend support to this idea. At the time of writing, Manado's mayor is being detained by the Corruption Eradication Commission for alleged misappropriation of the government budget for personal enrichment, whilst his vice mayor is facing a court allegation for corruption involving the development of a hotel in Manado. Regardless of whether these allegations are true, they are likely to create political uncertainty and negatively impact upon investment in Manado. In general, it seems possible that short term, exclusive, informal relationships can lead to more investment, even when the overall investment climate is poor. But in the medium term, the instability caused by corruption and rising inequality may undermine the effectiveness of this approach. By contrast, Solo's less spectacular progress may be more sustainable, although a longer time period would be needed to test this hypothesis.

Our study also suggests that it is important to understand the factors that make the investment climate good in some locations and not in others. Our conceptual framework spelled out a number of factors which may influence this and the evidence from our case studies appears to support many of the pathways described. For example, Manado appears to have a higher level of rent seeking because of a higher need for campaign funds, which in turn discourages reform of the bureaucracy. The financial independence of Solo's mayor, and his loose affiliation to the party system diminish the incentives for rent-seeking there. Similarly, the exclusive relationships between Manado's executive and key large investors is heavily influenced by the concentrated nature of the investment opportunities as well as the background and skill set of the current mayor. In Solo, the sociable personality of the mayor has shaped his much more inclusive approach, whilst his strong managerial background has enabled him to attempt systemic reforms of the bureaucracy. The same differences in skill set have also influenced the different approaches to planning in the two cities.

The broader political and institutional environment has also played a role in shaping the investment climate in each location. Yardstick competition between different districts around Solo has encouraged better performance, but appears to be ineffective in Manado. A broad range of interest groups ensure an inclusive approach to public policy in Solo, whilst their absence in Manado accommodates narrower coalitions; and the quality of political and technical leadership clearly differs markedly between the two locations.[18]

This study poses a challenge to conventional thinking on the investment climate. We have shown that narrow particularistic relationships between public and private sector actors are sometimes sufficient to trigger significant local investment, even where the traditional investment climate is poor. This suggests that policy may be better focused on encouraging a better quality of dialogue between the public and private sector around key investment opportunities, rather than pursuing a long list of generic investment climate reforms. At the same time we have pointed to a set of political, institutional and technical factors which influence the nature of the local investment climate. Gaining a better understanding of how these political constraints and incentives can be shaped to encourage the development of more sustainable local investment climates should be a priority for future research.

18 Solo's Mayor Jokowi has just been named one of the 10 Persons of the Year by the most influential magazine in the country, *Tempo*.

Appendix 1 Some indicators of rent-seeking, exclusiveness and poor planning

Investment climate aspects	**Indicators of rent-seeking**	**Indicators of exclusiveness**	**Indicators of poor urban planning**
Licensing	• Bribes for licenses • High cost for licenses • Unnecessary licenses • Lengthy time to get licenses	• Licenses are easy to get for some but hard for others	• No OSS or a poorly functioning OSS
Tax	• High taxes and *retribusi* (user charges) Unnecessary/ additional retributions	• Tax payments are waived for some • Tax repayments are processed more quickly for some than others	• Inefficient tax collection
Regulations	• Unnecessary additional *Perda* (local regulations) or other regulations which burden businesses	• Regulations do not have to be adhered to equally by all	• No regulatory review process identifying which regulations are needed
Land	• Duplicate land certificates • Difficulty in getting land certificate without payment • Access to land is costly	• Access to key pieces of land depends on relationship rather than open auction	• The lack of a land zoning or development plan. • Demarcation and access to land is not based on, or not consistent with the plan
Credit	• Credit is costly/ usurious	• Credit is allocated unevenly to those with close connections to the provider	• No plan for the development of financial services in the city
Security	• Police routinely harass businesses for bribes	• Security is provided to some but not to others	• Lack of effective system for evaluating and addressing security concerns
Infrastructure	• Bribes are required to get infrastructure facilities provided/ maintained	• Infrastructure facilities and invest-ments are designed to support particular investments associated with those close to power.	• Infrastructure investments are not made in accordance with a city plan.

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