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

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### **Introduction**

This study contributes to a broader research programme under the Centre for the Future State into how public action can stimulate productive private investment. The study explores the factors driving investment in two cities in Indonesia, and suggests that particular relationships between key political and economic actors were more important -- at least in the short term -- in boosting investment than more impartial, rules based governance.

### **Background**

Policymakers in developing countries are often advised to improve the investment climate by strengthening formal legal arrangements to protect property rights, facilitate contract enforcement and improve regulation. This is a valid long-term goal, but experience suggests that reform is often very difficult to implement, and may do little on its own to improve the prospects for growth. CFS research -- including this study in Indonesia -- is therefore interested in whether other factors, including informal relationships between key actors, can compensate for weak formal governance arrangements in the short to medium-term.

Indonesia undertook extensive decentralisation of administrative, fiscal and political functions to district level from 2001 (with elected district parliaments and district heads). Comparisons between districts enable researchers to hold constant some of the wide range of factors that might explain variations in levels of investment and economic performance, including political institutions, geography, resource endowments and population. This study looked at two cities -- Manado in North Sulawesi, and Solo in Central Java. They are broadly similar in terms of population and size of the economy, but display significant differences in the quality of local governance. The aim was to examine the impact of governance on levels of investment and economic performance. Researchers undertook 21 in-depth interviews and a survey of 50-60 small and medium enterprises (SMEs) in each city, supplemented by focus group discussions and secondary data sources.

### **Contrasting investment climates in Manado and Solo**

In Manado the regulatory environment is perceived as complex and confusing, and it provides considerable room for rent seeking. 82% of SMEs surveyed saw the licensing process as corrupt, with the majority using informal intermediaries (mostly government officials) to obtain licences. By contrast in Solo perceptions of the regulatory environment were much less negative, and licensing procedures have been streamlined through the establishment of an effective one-stop shop. In both cities, however, over 80% of SMEs still found the public tendering process opaque, complex and corrupt.

In Manado large businesses well connected to government receive preferential treatment. Small businesses lack channels of influence, and struggle to comply with the complex, corrupt and unclear regulatory environment. In Solo, there is a wide range of business associations that include different sectoral, ethnic and religious interests. Competition between them restricts rent seeking. The mayor has active contacts (both formal and informal) with a wide range of businesses that balance the different interests and are not perceived as skewed towards particular groups. Sectoral business associations are able to voice policy concerns. Overall, public and private interaction is much more inclusive in Solo than in Manado.

In Manado economic progress (for example reclamation of Manado Bay) was led by a small number of private sector actors rather than government, which lacks a coordinated plan. Solo by contrast, has an active development plan resulting from high levels of inclusiveness in policy-making. 70% of businesses surveyed thought of that government activities were well planned.

Underlying political economy factors that help explain the different investment climates in Manado and Solo include differently structured business interests, and differences in the background and leadership styles of elected officials (in Manado the mayor is a career politician from a poor background; Solo's mayor is a successful businessman with strong social and managerial skills).

### **Main findings.**

In both cities investment flows have increased significantly in recent years, but Manado has outperformed Solo. Despite its high levels of rent seeking, exclusive relationships between government and key economic actors, and minimal public planning, investment in Manado grew rapidly during the three years prior to this study, while investment in Solo, with a relatively 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 one might expect, given the more inclusive policies pursued in Solo.

External factors were important in explaining economic performance of both cities, including the general health of the national economy, and big increases in commodity prices which particularly benefited Manado. But qualitative evidence from the studies shows the importance of personal relationships. In Manado individual investors (for example in the bay reclamation scheme) depended on specific government permissions; in Solo an improved sense of economic security triggered investment. The cases suggest that the personal and particularistic nature of relations between local political leaders and investors was the key factor determining investment, not the broader investment climate; and that local policy-making influenced investment primarily by reducing the risks for large investors, rather than reducing costs of business for all. In the short term it may not matter much whether relations are exclusive or inclusive. However in the medium term political instability caused by corruption and inequality may undermine investment.

### **Implications for policymakers.**

The cases add to other evidence emerging from this CFS research stream, and suggest that policymakers should focus on encouraging a better quality of dialogue between public and private sector actors around key investment opportunities, rather than pursuing generic investment climate reforms. Policymakers also need a better understanding of how political, institutional and technical factors shape the local investment climate: this should be a priority for future research.