LPEM WORKING PAPER 17

TO SQUEEZE OR NOT TO SQUEEZE: CHARACTERISING THE INVESTMENT CLIMATE IN THE CITY OF MANADO, INDONESIA

Neil McCulloch
Arianto A. Patunru
Christian von Luebke

April 2009

LPEM-FEUI
Institute for Economic and Social Research
Faculty of Economics University of Indonesia

ABOUT LPEM FEUI

History

Institute for Economic and Social Research (LPEM) is an integral part of Faculty of Economics, University of Indonesia. More than 50 years through research, consulting and training activities.

In 1952 Prof. Dr. Soemitro Djojohadikusumo as the Dean of Faculty Economy of University of Indonesia, established 2 research centers: Business Administration Seminar and Social Research Center to support researches done by doctoral candidates. And then in November 1953, the Social Research Center became the Institute for Economic and Social Research (LPEM FEUI).

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TABLE of CONTENTS

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TABLES and FIGURES

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TO SQUEEZE OR NOT TO SQUEEZE: CHARACTERISING THE INVESTMENT CLIMATE IN THE CITY OF MANADO, INDONESIA

Abstract

Many countries have implemented investment climate reforms to try and boost growth and investment. But similar reforms have often given rise to quite different results in different countries. We hypothesize that success depends critically on the ability of local political actors to forge effective relations with the private sector. We explore this hypothesis through a detailed qualitative case study of the political economy of investment in the city of Manado, Indonesia. We find that the city bureaucracy and local parliament are largely focused on rent-seeking from the local private sector and that city planning is poorly implemented. Despite poor governance, investment is booming. Apart from exogenous factors, we find that local investment growth is sustained by hand-in-hand relationships between Manado's government leadership and large retail and property investors.

Neil McCulloch[1]
Arianto A. Patunru[2]
Christian von Luebke[3]

1. INTRODUCTION

Improving the Investment Climate has virtually become a mantra in donor development efforts over the last 10 years. It is now one of the central pillars of the World Bank's global development policy, and several other donors have extensive programs of work which fall under the label of improving the investment climate. However, the exact definition of the "Investment Climate" remains ambiguous. Some studies, such as the World Bank's Doing Business survey, use the term to cover only regulatory reform (World Bank, 2008). Others incorporate other major areas of public sector engagement, notably infrastructure, under the definition[4], whilst others again are even broader including aspects of political stability and macroeconomic policy.[5]

However defined, the underlying hypothesis of the last decade's explosion of work on the investment climate is clear: bureaucratic efforts that reduce financial and time

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[4] See for example the World Bank's Rural Investment Climate Assessments (World Bank, 2006).
[5] See Global Competitiveness Report amongst others (World Economic Forum, 2008).

costs of doing business and improve certainty for investors will yield higher growth rates and greater poverty reduction. Moreover, there is now considerable evidence, primarily from the major international institutions, indicating the negative growth impact of a poor investment climate.[6] But there is also a remarkable diversity of performance on growth and investment. In particular, some countries have pursued orthodox investment climate reforms (consistent with the 'Washington Consensus') and gained little by way of additional growth and investment; others have pursued decidedly heterodox policies, including trade protectionism, regional, sectoral and sometimes industry-specific subsidies, special economic zones, restricted competition and much else, and experienced rapid increases in investment and GDP.

There are several possible explanations for this diversity in investment and growth performance. ***First,*** economic policy is not the only factor that drives growth and investment. There is a wealth of economic literature on the determinants of growth and investment.[7] Typically, such growth regressions attempt to explain the influence on country level growth of geography (including location and natural resource endowments), factor endowments (population, human resources, availability of capital and land), institutions and policy (in particular investment climate variables), and historical performance. Thus differences in rates of investment and growth between different countries, or indeed between different regions within countries may arise because of differences in factors which have little connection with current investment climate policies.

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, in particular, has championed the idea that what matters is not implementing a large complex package of investment climate reforms, but rather identifying and fixing the binding constraints to growth at any given time (eg. Rodrik 2007). Thus countries which have followed traditional prescriptions for improving the investment climate may simply have focused on the wrong constraints.

Third, countries and regions within countries may succeed where others fail because they are more successful at managing the political economy of investment climate reforms. In other words, success may depend less on identifying binding constraints and more on the ability of politicians and private sector actors to build coalitions of interest around the implementation of specific policies to address key constraints. For example, Moore and Schmitz (2007) argue that in many developing country contexts, investment is spurred more by narrow particularistic relationships between the public

[6] See for example the extensive literature cited in World Bank (2005a).

[7] See Barro and Sala-i-Martin (1995) and Barro (1997) – Kong (2007) provides a recent review of the literature.

and private sector, rather than by the creation of an improved investment climate for all. If true, this would be an important challenge to orthodox economic advice which has focused quite heavily on the idea of creating "A Better Investment Climate for All" (World Bank, 2005a).

Moore and Schmitz also argue that many successful attempts to boost investment have been achieved by focusing more on reducing specific risks and uncertainties faced by particular investors, rather than by reducing the overall costs of doing business. The distinction between reducing costs and reducing uncertainty is far from new – see for example the economic work on uncertainty and investment by Pindyck (1991) and the World Development Report 2005 (World Bank, 2005a). However, the bulk of policy advice and most government efforts still focus on reducing the costs of doing business (World Bank, 2008). Thus it is useful to examine whether the focus of government efforts to improve the investment climate lies primarily in reducing costs, or in reducing uncertainty.

The literature on the determinants of growth is voluminous, and that on the binding constraints to investment is growing, but we currently know very little about the political economy of local level investment climate reforms. A broad literature about the political economy of economic reform exists (Krueger 1974; Rodrik, 1996; Haggard and Kaufman, 1995), but this focuses mainly on national level policies. This makes it difficult to draw general lessons about the political economy causes of differing economic performance across countries, because of the enormous variation of other potential causes of differential performance.

One way of overcoming this problem is to use within country studies, comparing regions which – whilst similar in geography, resource endowments and socio-cultural heritage –have quite different approaches to local economic governance in general and public-private interactions in particular. Case studies in each region can then focus on to what extent and in what way the political approach pursued in each region has influenced investment performance. In order for this to be a meaningful exercise, the regions chosen must have a significant degree of policy autonomy so that their performance could be considered the consequence of the choices which they have made. Such case studies should therefore be done in countries which have experienced a significant degree of political and economic decentralization.

Indonesia is one such country. It underwent a "big bang" decentralization in 2001 in which administrative, political and substantial economic policymaking authority was given to now over 480 local districts. This paper is the first part of a comparative investment climate study in two Indonesian cities: Manado in North Sulawesi and Solo in Central Java. It provides a detailed case study of the interaction between the public and private sectors and shows how this has shaped the investment climate and economic performance in Manado.[8]

In particular, we are interested in addressing two questions. ***First,*** what are the factors that have been responsible for the recent growth in investment in Manado and to what extent are the key drivers external factors or local economic policymaking? ***Second,*** what are the costs and risks of investing in the city of Manado and how are they shaped by the nature of interactions between public and private actors?

Our central hypothesis is 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.

We test this hypothesis by drawing together evidence from several in-depth qualitative interviews, two small quantitative surveys and a wealth of secondary data.

2. A BRIEF LITERATURE REVIEW

Public administrations tend to obstruct private economic activity by enacting distortionary regulations, inflicting superfluous administrative requirements, and capturing illegitimate rents (Batra ***et al.*** 2002; Djankov ***et al.*** 2002; World Bank 2006). This view finds support in three different currents of thought: literatures on public-choice saying that bureaucrats pursue private rather than the public interests (Tullock 1965; Downs 1967; Niskanen 1971; Breton and Wintrobe 1975), state-failure literatures that demonstrate how state regulations (trade quotas, permits and taxes) are misused for rent-seeking purposes (Krueger 1974, 1990; Srinivasan 1995), and corruption literatures about how bureaucracies with unconstrained powers are especially prone to corruption (Klitgaard 1998; Shleifer and Vishny 1998). These literatures conclude that governments need to be constrained by countervailing forces in order to provide public goods in efficient, responsive and non-corrupt ways. The forces which may achieve this are sub-national competition in decentralized regimes (Weingast 1995; Jin ***et al***. 1999; Zhuravskaya 2000; Besley and Case 1995), interest group pressures (Hirschman 1970; Putnam 1993; Becker 1983; Atkinson and Coleman 1989), and government leadership (Williamson 1994; Rodrik 1996; Grindle and Thomas 1989).

[8] See von Luebke et al (2009) on Solo, and Patunru et al (2009) for a comparison of Manado and Solo.

The Subnational competition approach has its roots in Tiebout (1956). The main argument is that in a decentralized environment where different policy-packages become visible, people are likely to move themselves and their assets to locations that serve their preferences best. Over time, this 'exit option' induces local governments to compete for mobile asset holders by means effective service provision and efficient revenue management. Besley and Case (1995) apply this approach to the context of local politics and argue that under decentralization, rational citizens can compare local politicians with counterparts in other districts. This comparison sets regional yardsticks and allows citizens to vote out officeholders once they fall distinctly below comparative benchmarks.

While the subnational competition model emphasizes the possibility of 'exiting' from bad policies, the interest group pressure approach highlights citizens' ability to 'collectively voice' for policy improvements. The key argument is that public outcomes and economic development are higher in areas with higher 'civic engagement'. 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. Accordingly, there has to be a set of 'selective incentives' for individual members: namely, awards for those who comply, and punishments for those who defect. Since selective incentives to mobilize large societal groups are often unavailable or costly, it is unlikely that large groups of citizens unite their efforts for concerted reform efforts. In contrast, in smaller groups members' action can be easily observed and coordinated; therefore these 'privileged groups' are more successful in collectively pursuing their interests. As a result, a minority interest group can dictate certain policies at the expense of the majority of consumers or taxpayers.

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: for example, 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 the seminal paper by Grossman and Helpman (1994). The authors develop a model in which special-interest groups make political contributions in order to influence the trade policies of an incumbent government. The interest groups bid for protection with their campaign support. Politicians maximize 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). Although our study focuses on local economic policymaking and its impact on investment, several elements of Grossman and Helpman's model may be relevant in this context too. In particular, different local interest groups may attempt to influence local economic policy – our empirical work attempts to explore the factors that determine the political equilibrium that results.

While sub-national competition and interest group pressure approaches focus on the demand-side factors of public service provision, the third factor, government leadership, tackles the supply side. It focuses on the extent to which governmental 'top-managers' play a role in securing an adequate supply of public goods. 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. Nevertheless, some scholars also warn of the detrimental effects of leadership. Africa's legacy of 'corrupt and non-visionary leaders' has proven to be 'a serious impediment to policy reform' that has left African populations 'tyrannized, and impoverished …over the past four decades' (Gray and McPherson 2001). It is important to be aware that leadership perceptions may be overestimated in some cases, since perceptions of the quality of leadership are influenced by economic performance, even when such performance may result from other factors. However, the accumulated evidence suggests that government leadership has made 'a critical difference in the introduction, scope and pursuit of policy reform' (Grindle and Thomas 1991)

3. THE INDONESIAN CONTEXT

Indonesia provides an ideal environment in which to explore the political economy of the local investment climate. The world's fourth largest country has undergone a remarkable transition over the last 10 years. For 30 years Indonesia was governed by a highly centralized authoritarian regime under President Suharto. Economic performance was extremely good with growth averaging 7% 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.

Indonesia has also undergone a "big bang" decentralization. Decided in 1999 and implemented since 2001, decentralization in Indonesia has been comprehensive with administrative, fiscal and political control for many policies being devolved to now over 480 district level governments. Hoffman and Kaiser (2006) argue that power was deliberately decentralized to the district rather than to the 32 provinces in order to counter secessionist aspirations among some provinces. The decentralization was defined by Laws 22 and 25 of 1999 which devolved to provincial and local governments a wide range of powers and fiscal resources.[9] District governments became responsible for the delivery of health, education, infrastructure and environmental services. The provinces were given a minor role, although their role has gradually been enhanced in subsequent amendments to the decentralization laws.[10] The new fiscal framework replaced the earlier system of earmarked grants with one of general allocation grants, the bulk of which are formula based. These grants constitute on average 93% of local government budgets (Lewis and Sjahrir, 2008).

Prior to decentralization districts were typically only equipped with the capacity to implement decisions from the centre. Decentralisation transferred two thirds of all civil servants from the central to the local governments, leaving local governments to cope with the expenses of these employees but not giving them the autonomy to hire or fire them. Concerns are frequently expressed about the lack of capacity at the district level particularly with the analytical, policy and planning functions that were previously done by the central government.

Notwithstanding these capacity deficits, the devolution of power to the districts has continued at a rapid pace. More than 30% 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 (DPRD) with representatives elected by the general population, and, since 2005, direct elections of district heads. Districts are responsible for most service delivery, local road building, and much regulation of the local economy.

Due to its rapid implementation, decentralization has also brought a plethora of new district level business regulations issued by the local parliaments. Whilst these are

9 These included all but a few functions retained by the center such as defense, national security, foreign policy, monetary policy, finance, development planning, justice and police.

10 Law 32 and 33/2004 are the current amended versions of Law 22 and 25/1999. The government is currently in the process of revising these laws again.

supposed to be consistent with national principles and are reviewed by the provincial and central governments, several commentators have raised concerns about imprudent or overlapping revenue instruments (Lewis, 2003a, 2003b) that harm local investment activities (Ray, 2003; SMERU 2001, 2002, 2003, von Luebke 2008).

The quality of the local investment climate has therefore become of increasing concern. Larger, formal sector firms must deal with national level bureaucracy – arranging permits and permissions, paying taxes and following national labor legislation. In addition, they now have to deal with local administrations often attempting to extract further rents from them. Top of the list of concerns of larger firms therefore is policy uncertainty, created in part from differences between national and local laws affecting their operations, along with corruption and macroeconomic instability (World Bank, 2005b).

However, the vast majority of firms and the bulk of employment at the district level are in small firms involved in farming, petty manufacturing and small-scale trading. These firms are subject to a plethora of local taxes, charges and delays, as well as random rent seeking by local thugs (***preman***) and village level officials. There is evidence that this is a bigger problem in an absolute sense for medium and small sized firms although it may proportionately more significant for very small or micro firms. Notwithstanding these costs, the principle investment climate concerns of smaller firms focus on basic infrastructural concerns including road access and the cost of transportation, as well as problems in accessing credit (World Bank, 2006). The resulting high cost economy creates thin markets and low demand, discouraging economies of scale and scope. Whilst some of these concerns are amenable to decentralized policymaking, others, for example electricity supply, are not.

The complex environment created by Indonesia's decentralization 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 centralized state, policy was uniform across the country. This ensured coherence and certainty, but also stifled local innovation. Under decentralization some districts have been able to undertake innovative governance reforms whilst others have not. Decentralization therefore presents an opportunity to explore whether efforts to improve the local investment climate at the district level have led to economic success and the way in which success depends on the relations between key private and public sector actors.

4. CONCEPTUAL FRAMEWORK

Our literature review combined with the context of decentralization outlined above allows us to hypothesize a simple conceptual model about what drives investment at the district level and how the nature of the local investment climate is determined. Our conceptual model is shown in **Figure 1**. Consider first a district which experiences a certain level of investment. In our stylized framework this may be as a result of two factors: firstly investment may be determined by a set of external variables (location, size of population or economy, infrastructure, and other factors); secondly investment may be determined by the nature and quality of the local investment climate created by local actors.

Let us consider first exogenous factors. As noted above, there are myriad reasons why a particular region or local economy may receive investment and grow.[11] These include aspects related to natural resource endowments (e.g. the presence or absence of oil, timber, minerals), human resource endowments (e.g. population size and level of education), its geography and location (e.g. proximity to major centres of growth), and its infrastructure (e.g. electricity, roads, ports). Whilst some of these are amenable to local policy in the medium-term, many are entirely exogenous or influenced only by national policies. It is important to remember the role of these exogenous factors when studying the local investment climate, since one may otherwise attribute too great a significance to the particular local policies pursued.

Estimating the relative contribution of such exogenous factors and investment climate variables requires a large quantitative dataset measuring these variables in a number of different locations. Whilst there have been a number of studies which attempt to do this in a cross-country setting (Dollar et al, 2005), the lack of sub-national data on a large number of regions has meant that there are relatively few studies of the determinants of local growth within countries. Fortunately, in Indonesia a very rich dataset covering many districts over a period of 12 years does exist. Fitrani (2005) and McCulloch and Sjahrir (2008) have exploited this data to try and estimate the determinants of local level growth. One of the most interesting findings from this work is that, although a few systematic influences on district level growth can be identified[12], a large part of the variation in district level growth is not explained by variations in their

11 The focus of this research is on investment. However, in many locations investment data is only available for medium and large enterprises (and often only for manufacturing), whilst investment climate improvements may stimulate significant investment by micro and small scale enterprises. We therefore focus on both investment and growth since growth includes the value-added created by such small-scale investments.

12 These include conditional income convergence, so that, conditional on endowments and other variables, poorer places tend to grow faster; as well as spatial concentration in the sense that districts that are located beside fast growing districts also tend to grow faster.

endowments (such as their distance from Jakarta, sectoral focus or quality of infrastructure). This supports the idea that there may be an important role for political economy factors.

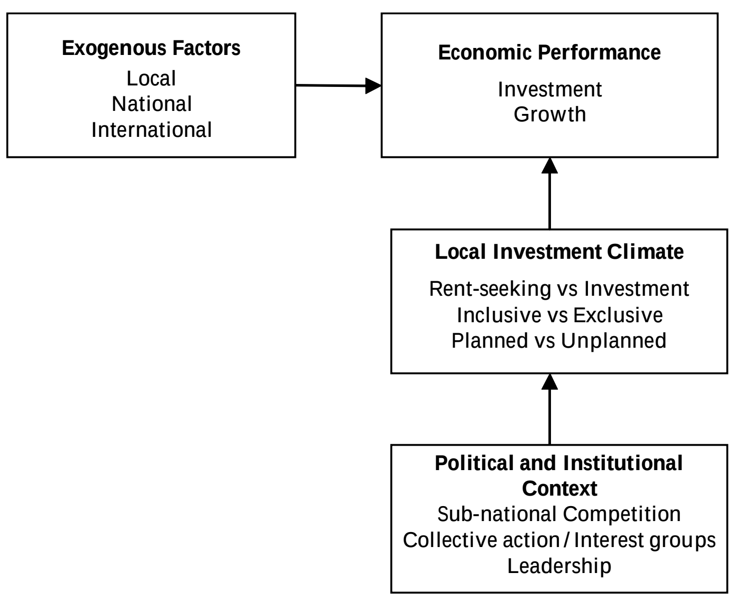
After considering the external factors that drive investment, our primary focus is to assess the way in which the local investment climate may influence investment. Here we characterize the local investment climate along three different dimensions:

a) ***Rent-Seeking vs Investment Facilitation:*** the government can focus on extracting rent from the private sector with no discernable benefit to private sector investment – or it can focus on maximizing growth and investment with relatively low rent extraction.

b) ***Inclusive vs exclusive relations***: the government can focus on the creation of an impartial investment climate accessible to all – or it can focus on facilitating access to investment opportunities for key economic players with close connections to the government.

c) ***Planned vs unplanned***: whether or not the development is planned in a transparent and strategic way or is done in arbitrary and ad hoc way based on whatever individual investors wish to do.

Figure 1: Conceptual Framework for Study



Whether the local investment climate is more or less rent-seeking, more inclusive or exclusive, and more or less planned depends on a complex set of interactions between the key actors at the local level as well as their relationships with provincial and national government. The key local actors are the elected executive – most notably the mayor himself, the bureaucracy, the local parliament, and the private sector itself. We therefore consider below how the sorts of incentives that these actors face may give rise to different types of investment climate in different locations.

Rent-seeking vs Investment Facilitation

Consider the incentives faced by a city mayor in Indonesia. As noted above, mayors are now directly elected by local citizens. They therefore have a strong political incentive to attend to local constituencies by stimulating higher investment and growth.[13] One way to facilitate this is through public expenditures which are supportive of private investment and complementary to private capital. These include public services (such as licensing agencies, land titling agencies, road repair, electricity provision and so forth) as well as investments in new public infrastructure (roads, markets, generators etc). Providing these requires revenue, at least some of which must be obtained by taxing the private sector. But such taxation is not rent-seeking – to the contrary, if the public expenditures which use this revenue promote positive externalities, then such taxation will help to boost investment.

In practice, local leaders interested in maximizing the size of the economy do not have to resolve the traditional problem of determining the optimal tax rate that will minimize disincentives to invest and maximize the complementary impact of public expenditures. This is because, in the Indonesian context, typically over 90 percent of local budgets come from national taxes and transfers. Thus the key problem for a local leader is not primarily determining the aggregate level of local taxation, but rather lobbying the central government to increase the size of the transfer. However, the local leader is responsible for the implementation of public expenditure, including selecting and implementing the particular public services and investments which are likely to be most conducive to private investment. Some public expenditures may be extremely complementary to private investment –others may (at least for that purpose) be worthless.

[13] Consistent with Olson's argument on 'stationary and roving bandits', the strength of these incentives may depend strongly on how long the mayor expects to be in office (Olson, 1993, 2000).

What factors determine whether local taxation and expenditure promotes or hinders investment? One is the technical quality of local leadership. Identifying which public expenditures are key is a complex task, as is managing their effective implementation. Similarly recognizing which private expenditures are worthy of support and what types of support might be most appropriate requires considerable technical skill. Thus some regions may receive more investment simply because their leaders are better managers. The same argument holds for the local bureaucracy and the local private sector. Planning, budgeting and implementing government expenditure effectively requires considerable skill. Administrations with better technical skills are likely to improve the investment climate more effectively than those without them. And skills shortages do not only exist in the public sector; regions with more highly skilled private entrepreneurs are also likely to do a better job at identifying and implementing successful investments.

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 local leaders "optimal" choice of 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 (e.g. through collusive or preferential public project allocations).

The extent to which the local investment climate is "extractive" will therefore be driven by a number of factors. One is the need for campaign funds. If expenditure on political campaigns is limited by law and political parties receive significant public funding, then local leaders will have less need to extract campaign contributions. However, this is not the case in Indonesia. Indeed Mietzner (2007) shows that the cut in state subsidies for parties in 2005 has contributed to a significant increase in their illicit fund-raising efforts.

A second factor influencing the extent of extraction will be the nature of the mechanisms for political promotion and demotion. Since mayors are now directly elected there is an opportunity for the electorate to remove mayors that are too obviously extractive (see Henderson and Kuncoro, 2006). But leaders are also influenced by the possibility of political career advancement. If the party to which the leader belongs tends to reward good economic performance, then the leader is likely to minimize distortionary extractions. On the other hand if political advancement depends more on short-term financial contributions to national party boards then leaders may be less concerned with fostering local investment.

Third, the level of extraction will depend on the probability of being detected and the nature of the sanctions applied when irregularities are uncovered. Clearly environments with weak legal and political checks are likely to see greater extraction than situations where enforcement is tight and convictions end political careers.

Last, the level of extraction will depend on the venality of the individual leader. Interestingly, individual morality is one of the main areas of focus in the debate around corruption. Clearly it plays a role – leaders that on principle eschew any form of corruption are likely to extract less than those whose individual greed is well known. But it should be recognized that individual morality is only one of several factors that will influence extraction rates, and not necessarily the most important one.

Inclusive vs Exclusive Relations

The second dimension of the local investment climate that we wish to assess is the inclusiveness of economic policymaking. The idea of the investment climate model promulgated by the international institutions is that investment will be greater (and more equal across different kinds and scales of activity) if investment climate services are provided in a non-discriminatory, transparent, and efficient fashion, that is, everyone pays tax due regardless of who they are; regulations are applied in an impartial fashion; land access is determined by commonly agree principles; credit is provided based on expected profitability only; licensing is impartial, transparent, quick and cheap; the police operate in an impartial fashion; and infrastructure investments are based on economic cost-benefit analysis rather than preferential treatment for one group over another. We call this "inclusive" policymaking since the intent is to provide a level playing field for all economic actors regardless of who they are.

On the other hand if the investment climate functions of government are provided in a partial and non-transparent fashion then we might expect a small number of key business actors to have good access, and therefore do most of the investment, while the majority of firms would be excluded from key opportunities and therefore do little investment.

It is worth exploring the reasons why some local governments may exhibit inclusive relations with the private sector, whilst others prefer more exclusive or particularistic relationships. Consider again the options open to a local leader wishing to boost local investment. As noted above, one way to support this is through effective public expenditure. But there is a second way in which local leaders can maximize private investment which relates to the encouragement and facilitation of specific private investments. Given limited time and resources, local leaders cannot be involved in facilitating all local private investments directly. But there may be particular, strategic private investments which they deem to be important. By ensuring the smooth passage of such investments through the bureaucratic process, or simply by signaling their political support for such ventures, local leaders can encourage these specific investments.

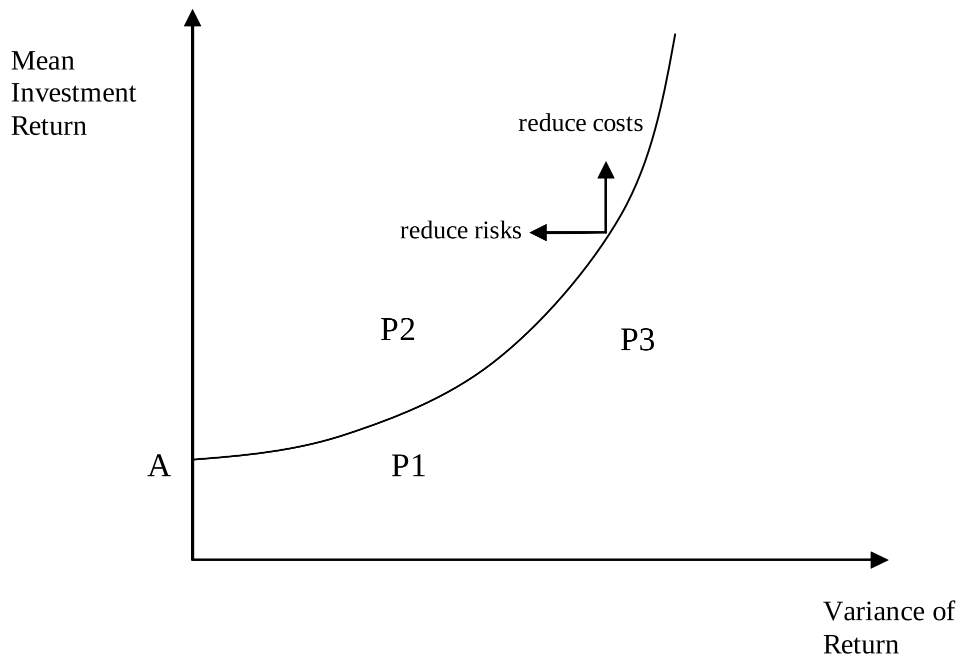
The tension between these two approaches to encouraging private investment – complementary public expenditure and support for selected private investments – can be illustrated in a simple diagram. **Figure 2** shows a mean-variance indifference curve for the average private sector investor. Assume an investor is capable of obtaining a guaranteed low return at point A. In order to invest in a project whose returns are more risky (higher variance), the investor requires a higher expected return – hence the indifference curve slopes upwards. Moreover, if we assume that the investor is at least somewhat risk-averse then the return that they will demand will rise faster the larger the riskiness of the project, so that the curve is convex.

Now consider three possible projects, P1, P2 and P3. P2 is above and to the left of the indifference curve, indicating that it yields a high return given its variance – a private investor will clearly go ahead with such a project. Similarly P1 and P3 both lie below the indifference curve, the return of P1 is too low, given its variance, whilst the riskiness of P3 is too high, given its return. In both cases investors will not proceed. Now consider the effect of the two types of government action described above. Efforts to implement public expenditure which is complementary to private investment can work in two ways. Either they will reduce costs and therefore increase returns for all investments (shifting all projects upwards in **Figure 2)**; or they will reduce risks for all investments (shifting all projects left in **Figure 2**). If these effects are large enough, then potentially a large number of previously unattractive private investments could now become attractive, stimulating a boost to local investment.

But note there is a cost to the local leader of adopting this approach. He or she must identify the most appropriate public expenditures, shepherd the budget through the local parliament and then closely monitor and enforce proper implementation, all time consuming tasks. Moreover, the gain in investment achieved depends on the extent of the cost and risk reductions achieved, as well as the density of potential investment projects which are sufficiently close to the indifference curve that they would be affected by the cost and risk reductions achieved.

The alternative approach for the local leader is to pay less attention to public expenditure and more to facilitating specific private investments. Assume that the local leader believes that the potential cost and risk reductions associated with public expenditure are likely to be small, or that the costs of achieving them would be high, or that very little additional private investment would be induced by such changes. Further assume that potential investments P1 and P3 are very large. In such a case it may make more sense for the local leader to focus on reducing the costs or risks of these specific investments.[14] This may be much easier to achieve and potentially could create more investment than attempts to improve the broader investment climate through public expenditure.

Figure 2: Mean-variance indifference curve for potential investments



In what circumstances are leaders likely to focus on improvements in the general investment climate through public expenditure, rather than specific support to particular private investments? **Figure 2** makes it clear that the optimal approach will depend on the size and distribution of investable opportunities. If the vast majority of potential investments that are sufficiently close to the indifference curve are small with only a handful of large potential investments, we would expect to see local leaders focus on these larger projects. On the other hand, if the aggregate size of potential investments

[14] Of course the local leader may be interested not only in the total amount of the investment, but also the character of the investment e.g. whether it creates many jobs and has other positive or negative spillovers into the local economy.

near the indifference curve is much larger than the total size of the large specific investments, then we would expect that the focus would be on improving the general investment climate.

It is of course extremely difficult to assess empirically the relative size of, as yet unrealized, potential investments. However, we might expect that in regions which are less well developed, the potential gains from general improvements in the investment climate may be smaller, simply because the size of the economy is smaller. Similarly in regions that are rich in natural resources the main opportunities may lie with a handful of relatively large private investments. Conversely in richer and more diversified regions the benefits of general improvements in the investment climate may be more significant, relative to the size of new individual investments. Hence, holding everything else the same, we might expect that leaders in poorer or natural resource rich regions will focus more on trying to facilitating specific relatively large investments in their regions, whilst leaders in richer regions focus more on more systemic improvements in the investment climate.

There may also be political motives for exclusive relations between the government and the private sector. One we have already noted – the transaction costs of extracting funds from a few large individual investors may be substantially lower than from myriad small ones (although local leaders may choose to do both). But the key factors determining the balance of focus between inclusive and exclusive relationships between the government and the private sector may well be the rigidity of the bureaucracy itself and the technical and political skill of the executive in managing reform. Where bureaucratic reform is difficult (e.g. because of institutionalized corruption) and the executive's skills are weak, they are more likely to focus on exclusive relationships with a handful of key business players.

Planned vs Unplanned Development

The third dimension we explore is the extent to which 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 haphazard and unplanned fashion. Again there is no presumption that either approach will give rise to more or better investment – overly restrictive plans might reduce the actual investment that takes place, whilst an unplanned approach might have negative spillover effects on the surrounding areas. 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.

Note that planning does not necessarily imply exclusive or particularistic relationships. It is possible to have a plan which is impartial and efficient. For example, one could have target sectors, or target regions, but which are open to all actors in the relevant sectors or regions. Similarly, target projects could be openly tendered and public assets could be fairly allocated through auction. The key distinction between planned and unplanned is whether the government seeks to direct the nature of investments that are made (either by sector, location or type) to try and maximize the social benefit of the development for the region, or whether it simply leaves these decisions to the private sector. By contrast the key distinction between inclusive and exclusive policymaking is whether policy and practice affords all actors or firms an equal opportunity to participate in local economic development.

Although each of the three dimensions along which we characterize the local investment climate are clearly continuous, it may be helpful to consider some extreme "types" of local investment climate that can arise from this characterization. The stereotypical "good" investment climate might be characterized by a local government that is investment oriented, inclusive, and has a clear plan for how it intends to boost the local economy. Conversely, one could envisage a local government which was intent on extracting rents from the vast majority, whilst favoring a small number of well connected firms or individuals without consideration of any real plan for the development of the area.

However, note that many of the other combinations are also plausible. For example, the situation above in which a predominantly rent-seeking government gives favor to a handful of individuals might actually be better for the local economy than one in which a rent-seeking government was "inclusive" in the sense that all economic actors were equally squeezed with none being favored. Similarly one might envisage a local government that has a clear plan for local economic development, but implements this plan through exclusive arrangements with a few key actors, whilst extracting as much rent as possible from the rest of society. Such a "rent-seeking, exclusive, planned" government might actually be as effective in attracting investment as one in which the typical exaction was lower, but which, because of its concern for equitable treatment, was less inclined to offer the sorts of incentives likely to attract some key investors.

Thus for each of the three dimensions along which we measure the investment climate – rent seeking vs investment; inclusive vs exclusive; planned vs unplanned – we wish to examine whether they have the expected influence upon investment. Is it the case that rent-seeking environments have worse investment performance?[15] Does an inclusive approach to economic policymaking give rise to more investment in aggregate than an exclusive approach; is investment broader-based with a more inclusive approach? And is it necessarily the case that districts with a clear plan for private sector investment fare better than those that let the private sector develop whatever and wherever they wish?

Broader factors which influence the character of the local investment climate

Finally, our conceptual framework looks at the broader determinants of the type of investment climate observed. What are the factors that influence whether an area has an investment climate that is more oriented to rent-seeking rather than investment, is more inclusive or exclusive, is more planned or unplanned? As noted above, the literature points to three aspects of the political and institutional context which may shape the nature of the local investment climate: sub-national competition; collective action (whether broad-based or by various interest groups); and the quality of leadership.

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; but equally local actors may be able to put pressure on a local government to be more inclusive in their application of public policy, by publicizing the good examples of neighboring districts. It is not clear apriori how much influence sub-national competition is likely to have. The arguments for the importance of sub-national competition are built on a set of assumptions that rarely match the institutional and socio-economic conditions in Post-Suharto Indonesia. In most local polities, citizens continue to be constrained in their access to information, education and alternative service providers. Whether economic or political 'yardsticks' are influential in the Indonesian context is therefore an empirical matter.

Similarly, different types of collective action 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 often fare better through their personalized contacts with senior government figures, whilst myriad smaller firms fail to organize themselves due to coordination and

15 The cross-country empirical literature is divided on this point – see Aidt et al (2005).

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, just as with sub-national competition, there may be exogenous factors which condition the nature of collective action. For example, districts in more remote districts with sparser markets and only a few key resources are more likely to be susceptible to narrow interest group politics than regions in denser economic areas with a broader range of economic actors (Moore, 2004).

Leadership also will play a key role in determining the nature of the local investment climate (von Luebke, 2008). But explaining the nature of the investment climate merely in terms of the quality of leadership is unsatisfactory since it begs the question, "why did this region get a good leader and another region 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.

Methodology

To explore the questions outlined above it is necessary to undertake detailed qualitative fieldwork. We therefore picked one city, Manado in North Sulawesi, as the location for our study. Manado was picked for two reasons: first, it is an economic center with high resource endowments and tourism prospects making it more likely that investment climate issues are considered important; secondly, we were able to utilize preexisting administrative support networks. A local NGO provided direct access and assistance for our survey of the political economy of the local investment climate.

The fieldwork, which was conducted between 5-17 November 2007, consisted of a more than twenty in-depth interviews with local firms (both large and small), media representatives, NGOs, a range of government bureaucrats, the Deputy Mayor, and parliamentarians.

The rich qualitative data from these in-depth interviews was further complemented by three additional sources of information. ***First,*** we conducted a small business survey with 52 local SME (across Manado's key economic sectors) in order to quantify local perceptions on the investment climate. ***Second,*** we invited a number of small and medium firms to a focus group discussion to cross-check the core drivers of and obstacles to local investment. And ***third,*** we analysed an existing survey of small firms focusing on licensing issues, and compiled a range of secondary data sources – namely government regulations, public budgets, credit statistics and newspaper clippings – to triangulate the evidence emerging from the interview data.

The economic performance of Manado was estimated on both quantitative and qualitative grounds. In a first step we collected available economic statistical data, including GDP figures and outstanding investment loans at local banks . These quantitative indicators were then enriched with the interview data from local firms, academics, NGOs and journalists. In particular, respondents were asked to describe their perception on local investment and economic performance , both in terms of general tendencies over time and concrete local examples

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. In keeping with the conceptual framework above, we were particularly interested to understand extent to which these investment climate indictors relate to the underlying characteristics of the public-private action. In other words, do rent-seeking, exclusive relationships, and non-transparent and ad-hoc planning coincide with a poorer investment climate? In order to assess this, it is useful to outline how these non-conducive characteristics can be observed in the context of common investment climate indicators (see **Table 1**)

To give an example, if several respondents report the need to, say, bribe officials in order to obtain licenses, we would take this as evidence of rent-seeking behaviour (and conversely, the reported absence of such bribes would indicate a stronger investment orientation). Similarly, if access to key pieces of land depends on who you are rather than being the result of an open auction process, we would take this as evidence of an investment climate characterized by exclusive relations. Throughout we encouraged private sector respondents to talk about the issues that they were most familiar with or which caused them the most difficulties in order to identify which aspects of the investment climate matter the most. We put special emphasis in the interviews on identifying incentive and power structures of the key local actors and on linking these incentives to the investment climate observed.

5. CHARACTERIZING THE UNDERLYING INVESTMENT CLIMATE

Following the conceptual framework laid out above, we characterize the investment climate along three dimensions: Rent-seeking vs Investment-Focus; Inclusive vs Exclusive relationship; and Planned vs Unplanned development. We then briefly discuss the evidence about broader factors influencing the local investment climate.

Table 1: Indicators of Rent-Seeking, Exclusiveness and Poor Planning

Investment Climate Indicators	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 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*** 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 get land certificate without payment Access to land is costly	Access to key pieces of land depend 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 investments are designed to support particular investments associated with those close to power.	Infrastructure investments are not made in accordance with a city plan.

Rent-Seeking vs. Investment Focus

To assess the extent to which the government of Manado's policies are more oriented towards rent-seeking or towards investment, we explore four salient policy areas: **(1)** the regulatory environment , **(2)** business licensing; **(3)** business-related public services and; **(4)** public tendering.

Regulatory Environment

The regulatory environment in the city of Manado is complex and confusing. The interviews with business respondents clearly suggest that the local government has enacted a set of local bills (***perda***) that exact imprudent user charges (***retribusi***). The legal justification for many of these user charges is unclear, often due to poor coordination between the local and national governments. For example, there is a local regulation on the production of alcohol. Because of the discriminatory nature of this regulation, the ***perda*** was revoked by the Constitutional Court in Jakarta. However the charge continues to be applied in Manado because the local parliament (DPRD) has not yet implemented the court's decision by revoking the Perda. Another example deals with the trading license (SIUP). It has been decided by the Minister of Trade[16] that this license should be given without any fee. However, as the DPRD has not adjusted the corresponding ***perda***, local bureaucrats still impose fees on local firms for obtaining standard business licenses. The chair of the Economic and Finance Commission of the local parliament acknowledged that the local parliament has difficulty in keeping up with frequent changes in legislation in Jakarta, particularly those arising from the frequent ministerial decisions and circular letters. In theory, the legal structure of decentralization does not require local government to comply with these lower forms of regulation from Jakarta, but in practice these all require changes in local regulations and subsequent approval by the local parliament. As a result, much of the work of the local parliament is taken up in amending local regulations to fit with national laws and decrees. A number of respondents claimed that the resulting confusion regarding the legal status of various charges provides room for rent-seeking.

Rent-seeking is also evident in regulations on trade across local jurisdictions. Charges on transportation between regions within North Sulawesi provide a case in point. One respondent reported that a given truck shipping rice from Bolaang Mongondow to Bitung (160 km, passing three jurisdictions) has to deal with about twenty different retribution posts along the road (including illegal exactions), adding around 2-3% to the final cost of the product at the destination. Several business respondents shared this view and complained about the frequent and imprudent extraction of user charges. Whilst some argued that firms that comply with all the relevant regulations could avoid being troubled by the police or government officials, many others claimed that even full compliance did not guarantee the absence of harassment.

[16] See Ministerial Decision No 36/M-DAG/PER/9/2007.

Licensing

Getting the licenses required to legally operate a business in Manado is 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 legal status. However, all of them had business registration and trade licenses and almost all had at least three other common licenses (building, location and nuisance licenses). The principal reason given for obtaining these licenses was to avoid fines and legal and illegal exactions – almost no respondents stated that the licenses helped them to get access to credit or local markets. 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 official acting outside their normal duties. Respondents stated that this saved time in the processing of licenses, and senior officials responsible for the collection of license fee openly admitted that they "picked up the ball" i.e. processed licenses for busy business people in return for payment. 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 (**Table 2**).[17] The majority of respondents found it difficult to access information about licensing. Similarly, the bulk of local firms in our survey felt that license procedures involve a substantial amount of administrative red tape . Most striking, however, is the fact that more than 80 percent of the survey respondents regard the current licensing practices in Manado as corrupt.

The unnecessarily complex licensing environment is well illustrated by the example of one businessman in the food and beverage industry. The nature of his business often involves transporting his products across cities and districts within the region. He gave the example that one of this trucks has a license to deliver goods from Manado to Bitung, while another truck has a license to deliver products from Manado to Tomohon. If the first truck breaks down, the current administration does not allow him to use the second truck to deliver the goods to Bitung unless he obtains another

[17] The survey covered 51 businesses, mostly in the service sector, notably trade and restaurants. The average number of employees is 6. Thirty-eight respondents reported that they never tendered for government's projects, while 9 respondents answered hey have worked with the government before.

license to do so. He is therefore obliged to own licenses for ***every*** jurisdiction and for ***each*** truck that he owns. In addition, he is required to obtain additional licenses from the provincial government for his trucking activities.

Another important problem is unclear or ambiguous licensing regulations that give rise to multiple interpretations. Several respondents described the case of a nationwide fresh bread chain-store which opened inside one of Manado's new malls. The police insisted that, because the store baked bread on the premises, it is an industry and therefore should have an industry license. The owner insisted that such a license is unnecessary since their business did not involve any large-scale industrial production. To press their point, the police arrested the manager and put up a police line to seal the store. The issue was only resolved when a local business tycoon, who was a friend of the store owner, called the mayor. Within one day the bread store received its license and the police withdrew from the scene.

Another often recounted case concerned the forced closure of a children's electronic game arena and toy store (also a nationwide chain). The police sealed the store accusing it of running illegal gambling because some of the game machines offer prizes for the winners. Again, the case was resolved by an important businessman who used his personal connection with the mayor. The mayor reportedly said that he intervened because he felt that what the police did could damage the investment climate in Manado.

Table 2: Perceptions on License and Tendering processes in Manado

	Access to information		
	Easy	Difficult	Total
License	20	31	51
Tender	8	42	51
	Complexity of procedure		
	Simple	Complicated	Total
License	20	31	51
Tender	3	47	50
	Fairness		
	Fair	Unfair/Corrupt	Total
License	9	41	50
Tender	4	44	48

Note: Figures refer to the numbers of firms. Perceptions were measured in Likert scales ranging from "very easy" (score 1) to "very difficult" (score 4). In this table "easy" includes scores of 1 and 2, while "difficult" includes scores of 3 and 4.

In general, many respondents expressed their disappointment with the police. One leading local businessman called the police a "superbody" who could do anything, whilst another government official dubbed them "kings who could do no wrong".

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. One businessman called the OSS a system of "one-roof office with lots of small roofs inside it" and another called it a "one-door house with ten tables inside". Several respondents expressed frustration that OSS services are much better in some of the neighboring districts in North Sulawesi. One of the reasons for the lengthy processing time for certain licenses is that they have to be signed by high level officials. One license (SITU), for example, has to be signed by the Secretary of City (Sekda). The Secretary himself admitted that this is not an efficient solution and suggested that licensing procedures should be delegated to a lower level.

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. Each office is reluctant to give up its revenue sources. Interestingly, some government officials from the Trade and Industry department (Disperindag) reported that they could help businesspeople to get licenses issued by ***other*** offices. Similarly, the Head of the Economic Department of the City Secretary admitted that his staff "pro-actively" visit businesses to check whether they already have all the required licenses. Often businesspeople, because they were busy, would ask his staff to "help them get the licenses", presumably for an additional fee. This practice was confirmed by an official in the Office of Urban Planning. She stated that, "we would never ask for a tip, but if we are given one we will take it".

It is, of course, difficult to know whether to characterize such behaviour as "rent-seeking". On the one hand, the licensing environment is far more complex than is necessary and probably kept so deliberately in order to provide opportunities for additional payments to be made. On the other hand, some civil servants are clearly trying to enforce the existing regulations and fulfill their bureaucratic responsibilities as efficiently as possible. Their efforts in providing a better service are frequently rewarded by businesses grateful for the reduced delays. This incentive mechanism probably results in faster services than might be the case otherwise, but also makes it more likely that business people who do not provide such "incentives" receive worse services.

Public Services

Rent-seeking also appears in the provision of public services. One respondent gave an example where he complained to the Office of Public Works (Dinas PU) about the poor drainage in front of his office building. However, when the Public Works department finally fixed the drainage in the area, they left out the segment in front of his building, allegedly because he refused to pay a bribe for the work to be done.

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 'volunatary payment'. Even when businesses don't complain they are often visited by officials seeking illegitimate payments. One businessman replaced all his old fire extinguishers which required maintenance every month, with new ones that did not. However, the fire department still demanded that he purchase stickers to indicate that his fire extinguishers had been checked for safety. Another official demanded that he pay an advertising charge for the label that he put on his products, even although the label was required by law.

Tendering

Theoretically, 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.[18] Similarly, parliament members are not allowed to become contractors for government projects. According to several respondents (including some government officials and parliamentarians), these rules are often violated in practice. However, most 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 Corruption Eradication Committee (KPK) and the Supreme Audit Agency (BPK). Several respondents also claimed that this improved transparency has come at the cost of slower administration for government contracts.

Nonetheless, almost all key business players agreed that tenders with government projects can still be manipulated in favor of individuals or groups close to the government. This can happen even when all the legal procedures and requirements are transparent. For example, one respondent alleged that the government sometimes puts a call for bidders in the newspapers, when the winner has already been decided. The perception that public tender procedures continue to be skewed towards the powerful few receives strong support in our local business survey. Roughly 9 in 10 respondents declare that current tender practices are non-transparent, complex and corrupt (see **Table 2**)

18 Although it is allowed to give small direct contracts to small- and medium-sized enterprises – see Keppres 80/2003.

The evidence above suggests that rent-seeking by the local government bureaucracy is common place 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 generalized extraction sits side by side with strongly 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.

Inclusive vs Exclusive Relationships

There are two aspects to whether or not relationships between the government and the private sector are inclusive or exclusive. Firstly, we can think of inclusion in the ***policy making process***. For example, are businesses frequently consulted about proposed new policies before they are decided upon? Are their views taken into account? And who exactly is consulted when policy decisions are being made?

Secondly we can consider inclusiveness or exclusiveness in terms of ***opportunities***. If new areas are being developed, who is given the chance to take advantage of these new opportunities? Is it a small group close to the government that benefits, or is access open to all?

Inclusion in Economic Policymaking

The evidence regarding inclusion in economic policymaking 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 Office for Cooperatives (Dinas Koperasi) who frequently consulted them on a wide variety of policy issues. Members claimed to be invited to discuss issues with the government several times every year and to be informed in advance of activities and programs 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 hassles and potential exaction, also may result in them not being consulted or involved in policy developments that do occur. This said, there is evidence from a number of respondents that the dissemination of information about licenses and retribution is far from ideal with much confusion about what regulations are actually in force at any point in time (**see Table 2**).

Unsurprisingly, almost all government departments claimed that they sought the views of the private sector and the broader community on policy issues. In some cases departments were able to supply evidence in support of their claim. For example, the head of the provincial Bank Indonesia pointed to the new policy adopted by the governor of the Central Bank that regional BI offices should "go to your neighbor". Bank Indonesia in North Sulawesi has therefore been involved in a large 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, KAPET, the 'integrated economic development zone' responsible for providing fiscal incentives to potential investors at the provincial level, clearly has a pro-active 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 (Dinas Tata Kota) stressed its pro-active efforts to ensure that the conditions, fees and processes required are widely disseminated. Similarly, the legal department was able to quickly supply books of all the local regulations (***Perda***), including a compilation of all local user charges (***retribusi***).[19]

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 KADINDA, the local chamber of commerce, despite the fact that almost all private sector respondents agreed that KADINDA 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 does appear to be available about regulations, retributions and licenses when requested. But there seems to be no serious attempt to involve the private sector in the policy making process.[20]

[19] 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.

[20] Some respondents said that one of the most effective channels of communication between the government and private sector was informal meetings with the Deputy Mayor. Several people said that the Deputy Mayor often goes and seeks opinions from local business people in local coffee shops and that he is quite open to discussing government policies.

On one point respondents agreed almost unanimously: the ineffectiveness of the local parliament (DPRD) in involving the private sector in deliberations about policy. Generally the views about the parliament were very negative ranging from "lacking in capacity" to "stupid and useless". Most private sector respondents thought that the DPRD was not very pro-business. For example, on one occasion when there was a problem with a local hotel, a member of the DPRD suggested shutting down the hotel instead of solving the problem. One respondent complained that the DPRD's sessions on the annual budget were very secretive and that even some DPRD members could not get access to the budget figures .

One of the reasons cited by the private sector for the parliament's poor performance is their lack of experience in business. Most respondents could only think of one or two of the 40 members of the local parliament that had a business background. However, all respondents agreed that many if not most of the members of the local parliament were government contractors. Being a government contractor at the district level ironically does not require any private sector expertise. Rather, contractors act as agents that use their political connections and influence with the local bureaucracy to secure government contracts. Officially it is illegal to be a government contractor if one is a member of the DPRD, but private sector respondents said that they thought DPRD members could get around this easily by operating through their friends or relatives. Thus it would appear that politically motivated private sector interests provide financial support for candidates (both for the parliamentary and mayoral elections). If successful, these candidates use their influence to try and secure government contracts for themselves or their funders.[21] Indeed, one businessman pointed out that the rational strategy was to supply funding to candidates in proportion to one's estimation of their chances of winning! This manner of operation is so commonplace that on one occasion a member of the DPRD promised a government project to a third party and when the third party did not then get the project, they reportedly complained to the police. When the member of the DPRD was confronted with this claim, he openly admitted that the promise had been made.

This rather negative view of the local parliament was even shared by some of its own members. One parliamentarian agreed that the DPRD was not very professional and that some people become members just to "follow the crowd". Another member admitted that there are a couple of members that like to ask for projects from the govern-

[21] Note that this is precisely the form of interaction predicted by the Grossman-Helpman model discussed earlier.

ment. Unfortunately, there appears to be little incentive for parties themselves to alleviate corruption or enforce discipline on their members and there are no significant sanctions in place for those who do break the rules. Nonetheless, the Deputy Mayor asserted that there had been improvement in the attitude of DPRD members. He attributed such progress to national good-governance policies which, in his view, have significantly reduced the incentive for DPRD members to abuse their position.

Another shortcoming of Manado's current parliament is the lack of consultation with the private-sector. While some parliamentarians claim that they frequently consulted the private sector in their legislative sessions on new local bills, the results in our business survey point in the opposite direction. Almost every respondent (50 out of 51) indicated that they were "rarely' or "very rarely" invited to parliamentarian sessions.

The parliament of Manado – composition and incentives

Manado's parliament has 40 members from the following parties:

Golkar	9
PDIP	8
P. Democrat	6
PDS	5
PPP	3
PKPB	3
PKS	2

And four others with only 1 seat.

There are four parliamentary commissions:

A. Governance (led by PDS)
B. Economy (led by Golkar)
C. Development (lead by Golkar)
D. Welfare (led by PKS)

The function of the local parliament is to make local legislation (***Perda***). In 2007 16 ***Perda*** were passed – the target for 2008 is 18. Much of the parliament's work consists of making local regulations consistent with national laws. Local laws must be submitted to the Ministry of Home Affairs in Jakarta for review and local parliaments can be ordered to cancel legislation if it is inconsistent with national law. This said, the decentralization laws (Law 32 and 33 / 2004) give substantial leeway for the creation of new local regulations. This leeway has been exploited heavily by most local governments, including the City of Manado. For example, for ***retribusi*** alone there are 30 ***Perdas*** in Manado.

The Manado parliament appears to have a good working relationship with the executive at the local level. The main reason for this is that the largest party (Golkar) is also the party of the mayor. The mayor came up through the party and was a member of the DPRD and at one stage the leader of a parliamentary commission. Hence he has a close relationship with most of the members of the parliament and a detailed knowledge of its workings.

The members of the parliament are subject to significant financial incentives. Some respondents claimed that the Economy commission is the most profitable place to be – indeed one pointed out that that is why the commission "has to be led by Golkar". Another former senior official stated that a significant share of the salaries of the DPRD members goes directly to their parties. This gives DPRD members a large incentive to "search for money". One way to achieve this is for the government to increase local own-source revenue (PAD). Indeed national law (PP 22 / 2007) requires the salaries of the DPRD members to be paid out of the local budget (APBD). Since the PAD is the only discretionary part of the budget under direct local control, the result is that DPRD members focus heavily on passing legislation and monitoring the implementation of activities which extract these revenues from the private sector.

Inclusion in exploiting new opportunities

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 are only a handful of businessmen that were involved in the reclamation of Manado bay. They include: a large Manadonese 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 national politician and former General and to the former leader of a national mass-based Muslim organization); and an investor originally from Makassar (South Sulawesi) with connections to senior national politicians in 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 short list 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. Such connections are also important for solving other licensing problems, as shown by the role of these key actors in resolving the licensing difficulties faced by the fresh bread firm and the children's game area described above.

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. One government official explicitly said that, given limited resources, it made sense for the government to focus on facilitating bigger investors through such a personal approach. The importance of close connections with senior government figures was well illustrated by their absence in the case of one property developer. He said that the licenses for his developments in South Minahasa and Manado have been stuck since May 2007. A former senior government official explained that the reason why his proposals were stuck was because the businessman "didn't use the personal approach".

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.

However, not all large investors necessarily receive preferential treatment – party connections appear to matter too. 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. Similarly, some respondents claimed that the origin of the investor also matters. For example, when one piece of reclamation land was disputed by two investors, the government made a decision in favor of the local investor and against the investor from Makassar.

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 done under the local regulations. However, there appears to be niches of influence for small firms too. For example one small home industry owner clearly had fostered excellent relations with the local Cooperatives department which ensured that she was always included as a beneficiary of their programs. Another small businessman who leads a SME business association had developed good connections with the local government owned enterprises who give subsidized credit to selected enterprises. But 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 minimize 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 favor of some businesses rather than treating all businesses equally.

Planned vs Unplanned Development

Most respondents agreed that the mayor has a clear vision for the city.[22] Moreover, Manado's government officials claimed that they had a master plan that also covers city planning.[23] 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 master plan, it was purely a private sector initiative. The memorandum of understanding between the investor and the government stated that all funding would come from the investor and in return the government would be given 16 percent of the land.[24] The subsequent phases of reclamation were also not laid out in any government plan.[25] In fact the ***perda*** 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 are currently sixteen ***perda***s under review, but the city planning ***perda*** is not one of them.

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[22] There seems to be many variants of Manado's vision. The Deputy Mayor said that the vision is to become a city of service and tourism. A journalist from Manado Post admitted that the government's vision is "good and clear" but the implementation is "bad".

[23] This is the RPJMD 2005-2010. The legal document for this is Perda 4/2005.

[24] Four MOUs were signed between the developers and the mayor in 1995.

[25] Two more MOUs were signed in 2000 under a different mayor. It is not clear why there were no MOUs between 1995 and 2000, but one businessman said that the 1998 crisis might be one reason; another businessman said that the mayor in this period was not very responsive to investment opportunity.

The lack of coordinated planning on the part of government is nevertheless 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 (such as they are) 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 ad-hoc in nature such as the plan to hold the World Ocean Conference (in line with Manado's vision to become World Tourism City by 2010) or those laid out by higher levels of government 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 northern part of the city, in the area called Mapanget, 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.

Evidence on the broader factors which influence the character of the local investment climate

Our conceptual framework also put forward three broader factors that might influence the nature of the investment climate: sub-national competition, interest group pressure, and leadership. There is some evidence that sub-national political pressure, in the form of embarrassment about the poor quality of licensing services in Manado relative to its neighbors, has influenced local policy. A ranking of the quality of local economic governance in 243 districts by Regional Autonomy Watch, a national NGO, ranked Manado at 205 (KPPOD / Asia Foundation, 2008). Manado's licensing services were ranked as the second worst in North Sulawesi and the integrity and capacity of the mayor had the lowest rank in the province and a very low rank across all the 243 districts surveyed. Such comparisons have caused embarrassment to the local government and may have created pressure for improvements. But there appears to be very little evidence that firms have moved location or shifted their investments as a result of the differences in the investment climates of districts in the region. Such decisions appear to be driven much more by the size of the market and Manado's position as a service centre for the province than by investment climate considerations.

Similarly, there appears to be little evidence that formal interest group pressure has constrained the actions of the executive. Manado appears not to have strong business associations pushing for reform – private sector influence is individual and personal. The only significant interest groups are the political parties. Golkar's domination of both the mayorship and the parliament may have been a force for stability thereby encouraging investment. But it has also reinforced the bureaucratic status quo from which it is likely to draw significant rents.

Thus the key factor determining the nature of the local investment climate would appear to be the character of local leadership. Here, the mayor's strong political position may have contributed towards the city's stability, and his vision for the city and willingness to facilitate key investments may have stimulated significant investment (see below). At the same time his lack of interest in implementing cleaner and more inclusive bureaucratic procedures and more systematic planning, is reflected in the bureaucratic and rent-seeking investment climate faced by the majority of smaller firms in the city.

6. ECONOMIC PERFORMANCE OF MANADO

Given pervasive rent-seeking by elements of the bureaucracy, limited involvement of most businesses in the policy making process, and the limited capacity within the government for planning new developments, one might expect investment performance in Manado to be poor. However, the literature and our conceptual framework suggest caution – the close personal relationships between key business actors and the executive may be sufficient to provide an attractive and secure environment for some investments, even if the general investment climate is less conducive. This section therefore reviews the economic performance of Manado over the last few years, whilst the next section attempts to draw together the key lessons from the evidence presented.

Manado is the capital city of the province of North Sulawesi. It had a population of 417,700 people in 2006 and a Gross Regional Domestic Product (GRDP) of US$ 1,316 per capita in 2005. Manado is situated on the shoreline of North Sulawesi. It is a growing tourist destination since it is close 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% 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. Being the capital city of North Sulawesi, Manado has better infrastructure and more modern financial services than other towns in the province.

Manado's relative prosperity is also reflected in its social indicators. The Human Development Index[26] of Manado is ranked number 8 out of 341 districts in Indonesia in 2004. Similarly, the Human Poverty Index[27] during the same period ranked number 12, far higher than surrounding districts.[28]

The economy of Manado is dominated by the tertiary sector, with the Trade, Hotel and Restaurant sector contributing 26.1% of GRDP and the Services sector 22.95%.[29] The Trade, Hotel and Restaurant sector also employs the largest number of people, contributing to around 30% of employment in Kota Manado and almost all of the outstanding investment loads in mid 2007 were in the Service (48.9%) and Trade sectors (44.5%).

The performance of Manado's economy has been improving over the last five years. The real Gross Regional Domestic Product (GRDP) of Kota Manado grew on average by 2.1% per year between 2001 and 2005, but, in keeping with the national trend, growth has picked up in the last few years and was 5.1% in 2006. **Table 3** shows the sectoral composition of this growth. GRDP Growth was fastest in the Trade, Hotel and Restaurant, and Construction sectors. This is reflected in the highly visible boom in construction that is taking place in the city. 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 also been constructed over the last few years.

This progress is also reflected in the investment data. Outstanding investment loans in North Sulawesi grew on average by 28% per year between 2003 and 2006, with 78% of the outstanding loans being made in Manado (**Table 4**).[30] 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 year between 2003-2006, with rapid growth also recorded for business services (57%) and construction

[26] The HDI is a composite index which combines per capita GRDP, life expectancy, literacy and enrollment.

[27] The HPI is a composite index which combines four measures: the probability of not living to age 40, the adult illiteracy rate, the proportion of people without access to safe water, and the percentage of children who are malnourished. The Indonesian HPI also includes the proportion without ready access to health facilities.

[28] The score for the neighboring districts were Bolmong (HDI 88 and HPI 140), Minahasa (HDI 38 and HPI 106), Satal (HDI 68 and HPI 65) and Bitung (HDI 59 and HPI 26) – see UNDP/BAPPENAS (2004).

[29] BPS Kota Manado, 2007

[30] Sulawesi Utara Local Economic and Financial Statistics, Vol 9 Bank Indonesia Sulawesi Utara, September 2007

Table 3: Growth in North Sulawesi by Sector (percent)

Sector	Average annual real GRDP growth (2001-2005)	
	Manado	North Sulawesi
Agriculture	2.9	-1.1
Mining	3.2	-6.2
Manufacturing	1.5	2.5
Electricity, Gas and Water	1.9	1.1
Construction	3.4	3.1
Trade, Hotel and Restaurant	4.2	3.6
Transportation & Communication	-0.4	0.1
Financial Services	-0.2	-1.8
Services	1.4	1.1
Total	2.1	0.6

(17%).[31] It is also possible to disaggregate outstanding credits to micro, small, and medium enterprises (MSME) by sector for both North Sulawesi and Manado.[32] These data also suggest strong growth in trade and services.

The data from **Table 4** suggest that micro, small and medium sized firms appear to have participated in the expansion. **Table 5** provides further evidence for this. 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 year between 2003 and 2006. However, 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% for medium-sized firms, but only 16% 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 of the respondents said that the high growth was mainly due to the reclamation project and the property investments that have followed. These have consisted of malls, supermarkets, "ruko" (***rumah toko*** – house / store-buildings) and "rukan" (***rumah kantor*** – house / office-buildings). Other respondents said that the economy is booming due to the high rate of

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

32 These credits include consumption, working capital and investment credits.

Table 4: Investment Performance in North Sulawesi and Manado

Sector	Outstanding Investment Loans August 2007 (Rp million)	Average annual growth in outstanding investment loans (2003-2006)	Average annual growth in credits to Micro, Small and Medium Enterprises (2003-2006)	Average annual growth in credits to Micro, Small and Medium Enterprises (2003-2006)
	North Sulawesi	North Sulawesi	North Sulawesi	Manado
Agriculture	28,505	-16%	24.0%	35.7%
Mining	2,229	123%	23.8%	110.3%
Manufactures	30,558	-20%	82.5%	6.4%
Trade	415,537	85%	17.3%	27.1%
Services	457,288	15%	24.5%	23.3%
Electricity, Gas and Water	59		19.2%	27.0%
Construction	81,227	17%	38.1%	12.7%
Transportation	187,120	6%	17.8%	1.1%
Business Services	168,792	57%	6.9%	33.6%
Social services	20,090	9%	21.8%	27.5%
Others	472	18%	35.8%	24.5%
Total	**934,589**	**28%**	**24.0%**	**25.0%**

Table 5: Outstanding Investment Loans by location and size of firm

	Outstanding Investment Loans (Rp million) End 2006	Annual average growth (2003-2006)
North Sulawesi	745,697	28%
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%

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. This is consistent with national socio-economic survey data which shows an increase in Manado's population between 1997-1999, a time of several conflicts in Eastern Indonesia. The population of the city is continuing to increase, albeit at a slower rate. Almost all respondents regarded the relative peacefulness of Manado as one of the strongest aspects of its investment climate. 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.

CONCLUSIONS

Our conceptual framework suggested a set of factors which are likely to make an investment climate more or less extractive, more or less exclusive, and better or worse planned. To a large extent the evidence from Manado supports this framework. Recent changes in election laws have greatly increased the need for campaign funds which would suggest more corruption. But the rise in national audits of local corruption, particularly in the executive, makes overt extraction more difficult. By contrast, although administrative corruption controls have tightened in recent years, evidence for elements of institutionalized corruption still remain. Thus our conceptual framework would lead us to expect relatively little overt exaction by the executive (which does not preclude the possibility of covert exaction) coupled with systematic petty extraction by the bureaucracy. This is exactly what we observe.[33]

The evidence on exclusivity of relations between the public and private sector also appear to support our framework. Manado is the centre of a natural resource rich province with relatively concentrated investment opportunities. The mayor is a career politician with no particular skills in bureaucratic reform and the bureaucracy is inflexible and, in some parts, institutionally corrupt. Thus our framework would lead us to expect a focus on exclusive, particularistic relationships with a handful of key investors which is precisely what we observe. Moreover, the inflexibility of the bureaucracy, coupled with the focus on exclusive relationships with a handful of large investors,

[33] In December 2008, the mayor Jimmy Rimba Rogi was arrested by the national Anti-Corruption Commission (KPK) on charges of misusing Rp 48 billion the local 2006 budget - around US$ 520,000. At the time of writing there is no verdict on the case.

tends to give rise to relatively unplanned development as the city's leaders respond in a reactive way to private sector initiatives.

Given the poor quality of many aspects of the investment climate under the control of the government of the city of Manado, it may seem somewhat ironic that investment over the last few years has been booming. But it is not inconsistent with our framework. In particular, we hypothesized that what may matter most for investment is the combination of good investment opportunities, and sufficiently strong and stable political leadership willing to reduce the cost and risks of key investments. Manado would appear to fit well with this characterization. There appear to be large opportunities to be exploited in the retail sector, as well as potentially large gains from tourism in the future. These encouraged large investments in malls and hotels, which in turn required political assurances that such investments would proceed without undue obstruction.

These results pose a challenge to traditional thinking about the investment climate. Many government and donor programmes focus on trying to improve the local investment climates by making them more impartial, ensuring broader participation in policymaking, and enhancing planning and budgeting capacities. The assumption underlying such measures is that investment-oriented, inclusive and well planned cities are likely to have more private investment. The evidence from Manado suggests that it is possible to attract substantial investment as long as there are reasonable investment opportunities, a peaceful environment, and a leadership interested in attracting investment and willing to support large investors.

But this relatively unorthodox approach to promoting investment in Manado, is unlikely to be sustainable in the long run. Investments which have strong benefits for one group at the expense of another – exemplified by the groups that gained and lost from the development of shopping malls on reclaimed coastal land – are likely to fuel political opposition and, thereby, undermine the ability to sustain future investments. The rise of political opposition, moreover, raises uncertainties about the executive's position which can have detrimental effects on the private sector's willingness to invest. Thus, as time and political awareness progress, the continuation of local investment may increasingly require a more reformist agenda to ensure that economic benefits are more equally distributed and to institutionalize impartial and less extractive government practices similar to those advocated in more orthodox approaches to investment climate reform.

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