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The New Zealand Asia Institute (NZAI) undertakes research focusing on engagement with Asia, provides a forum for informed debates, and offers a bridge to Asia-related expertise and research within the University of Auckland.

How do investors deal with legal uncertainty? Lessons from Indonesia's palm oil industry

How do we explain high rates of investment in palm oil plantations in Indonesia despite "wild west" degrees of legal uncertainty and uneven protection of property rights? These plantations are controversial and take years to pay off, yet in the Indonesian provinces of West Kalimantan and Riau, investment since the 1990s has literally ploughed ahead. An article co-authored by Natasha Hamilton-Hart comparing Riau and Kalimantan dissects the "informal relational ties" under which investment has flourished not merely despite, but because of, a lack of legal certainty and consistent property rights.*

The influential New Institutional Economics holds that would-be investors need assurances against government expropriation or other ways that power-holders might pull the rug from under them. In many Asian developing economies though, formal institutions such as the rule of law or generalised (consistent, jurisdiction-wide) property rights protection are absent or weak. We know that personal relational ties to local power-holders can sometimes give investors substitute forms of assurance that are informal and "particularistic" – specific to the investor and power-holder in question. But what actually creates and sustains such informal ties, often described as patronage?

The researchers distinguish two types of relational tie at work in the two provinces under study: clientelism and co-investment. Clientelism binds investors (clients) and power-holders (patrons) by an exchange such as money for votes or bribes for plantation permits. However, it depends on a delicate interdependence called "contingent reciprocity", which collapses if the client becomes dispensable. Co-investment can accompany clientelism but is distinct. It involves overlapping identities: political power-holders become investors, or investors become power-holders. Giving one party a stake in the other's interests again makes the investor less vulnerable to being undermined by the power-holder. In this study, co-investment relationships often consisted of so-called smallholdings (which in reality can be quite large) owned by local elites.

Both clientelism and co-investment are hard to measure. However, as a proxy, the authors measured the prevalence of conditions favourable to each in the two provinces, focusing on the prevalence of smallholdings as more conducive to co-investment. They also measured traditional institutional assurances such as the rule of law. Riau enjoyed fewer such assurances, yet palm oil investment there was both faster and more sustained – differences not explained by topography, infrastructure or price signals.

The study found West Kalimantan relied more on clientelism, whereas in Riau industry structure allowed greater co-investment. Co-investment meant Riau did not depend on the fragile conditions for contingent reciprocity, which depends on a degree of political centralisation and stability. Given that political conditions were fractured in both provinces, the lower level of co-investment in West Kalimantan meant that the province experienced more project abandonment and under-investment.

As to why there are provincial differences in these informal institutions, the authors venture that West Kalimantan's ethnic mobilisation against palm oil perhaps made it more costly for political power-holders to co-invest in palm oil, while also noting its many foreign investors could not acquire political roles. But watch this institutional space, because there is no reason why these factors must remain fixed.

*The full study results are available in an article authored by Natasha Hamilton-Hart and Blair Palmer: "Co-Investment and Clientelism as Informal Institutions: Beyond 'Good Enough' Property Rights Protection". Studies in Comparative International Development (2017) 52: 416–435.

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