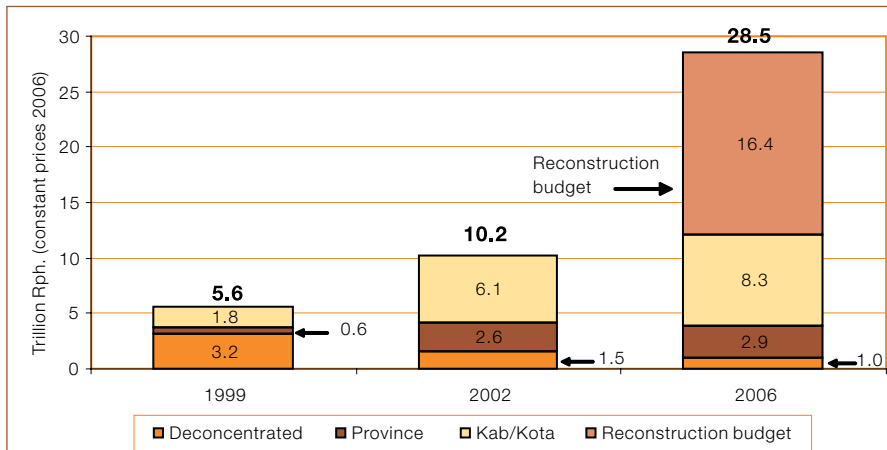


Executive Summary

Since 1999, Aceh's fiscal resources have increased dramatically. After decentralization and the Special Autonomy Status, the amount managed directly by the Acehese province and local governments increased several-fold. In addition, following the December 2004 tsunami, Aceh received an unprecedented amount of assistance from the Indonesian government and the international community. In 2006 total funds flowing into Aceh are estimated at Rp. 28.5 trillion (US\$3.1 billion). Most of these resources come from the reconstruction program (Rp. 16.4 trillion). Regular financing also is increasing rapidly and is expected to reach Rp. 12.2 trillion in 2006 (figure 1).

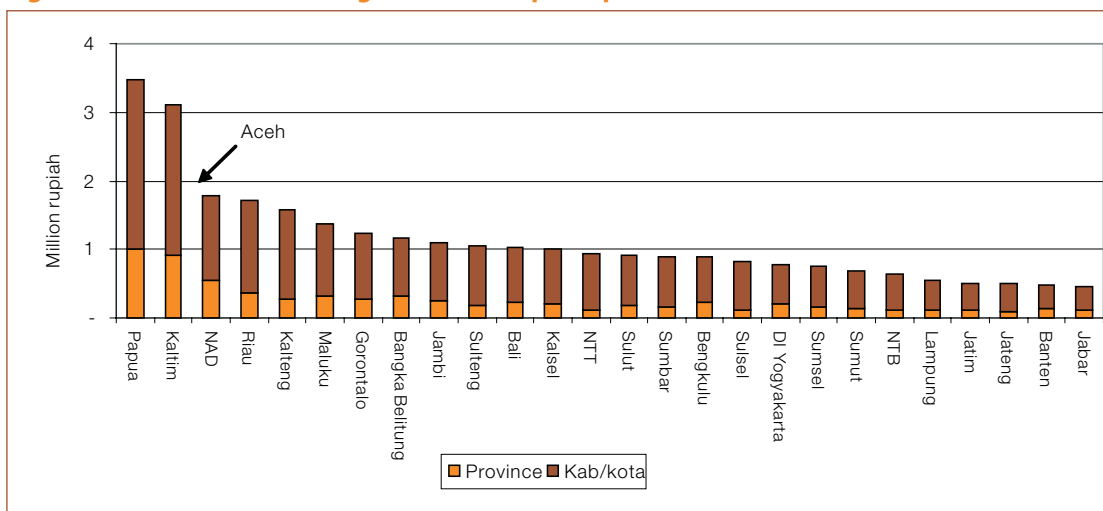
Figure 1. Aceh's fiscal resources have increased substantially, 1999–2006



Source: World Bank staff estimates (2006 constant prices) based on data from SIKD/MoF and BRR.

With this wealth, Aceh has the opportunity to reduce its high levels of poverty and improve public services. Aceh is the third-richest province in per capita revenues after Papua and East Kalimantan (figure 2). Aceh's revenues are double the national average and its relative ranking compared to other provinces will only get stronger with the implementation of the new Law on Governing Aceh (LOGA) (Law 11/2006) in 2008.

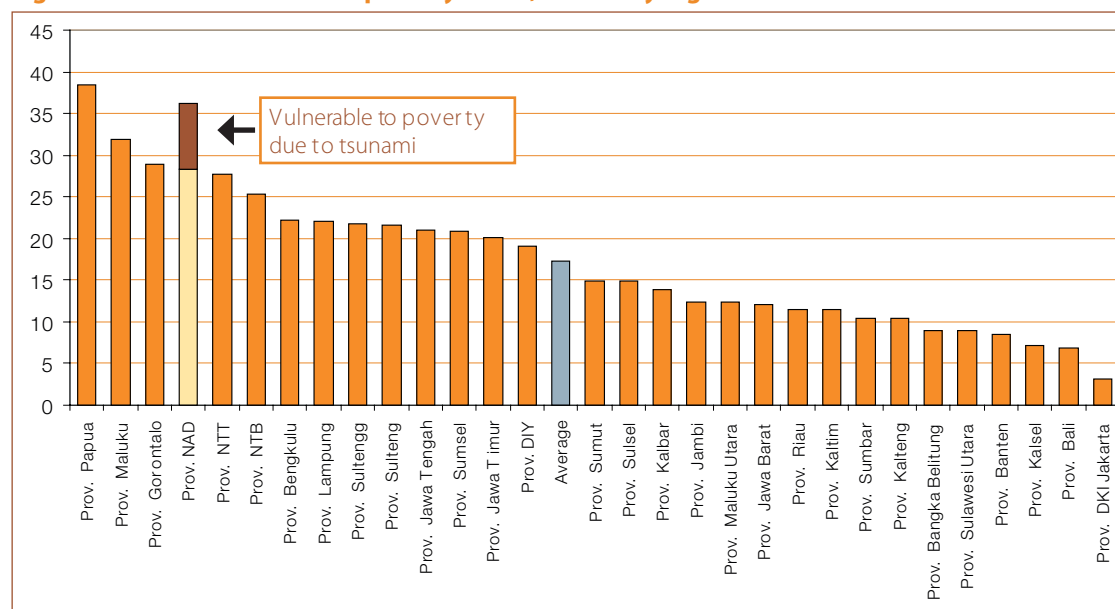
Figure 2. Aceh has the third highest revenue per capita



Sources: SIKD/MoF, World Bank staff estimates based on 2004 APBD.

At the same time, Aceh remains the fourth poorest province in Indonesia (figure 3). In 2004 an estimated 1.2 million people in Aceh (28.5 percent of the total population) were living below the poverty line (Rp. 130,000, or approximately US\$14, per capita per month). Thus, Aceh's poverty rate is almost twice as high as Indonesia's average poverty rate (16.7 percent). An additional 13 percent of the Acehnese became vulnerable to poverty after the tsunami.

Figure 3. Aceh ranks fourth in poverty levels, and likely higher after the tsunami



Source: World Bank staff estimates based on BPS, 2004.

The implementation of the Memorandum of Understanding between the Government of Indonesia and Free Aceh Movement, signed on August 15, 2005, in Helsinki, provides another opportunity to build a better Aceh and to deliver services to conflict affected-areas. The 30-year conflict between the Government of Indonesia and the Free Aceh Movement (GAM) claimed some 15,000 lives, dislocated several thousand families and caused massive destruction to public and private properties. The conflict also prevented the delivery of minimum public services in the areas worst affected by the conflict. The implementation of the Helsinki Agreement has been broadly on track and gives Aceh a chance to rebuild a peaceful society and regain economic prosperity.

Revenues and expenditures

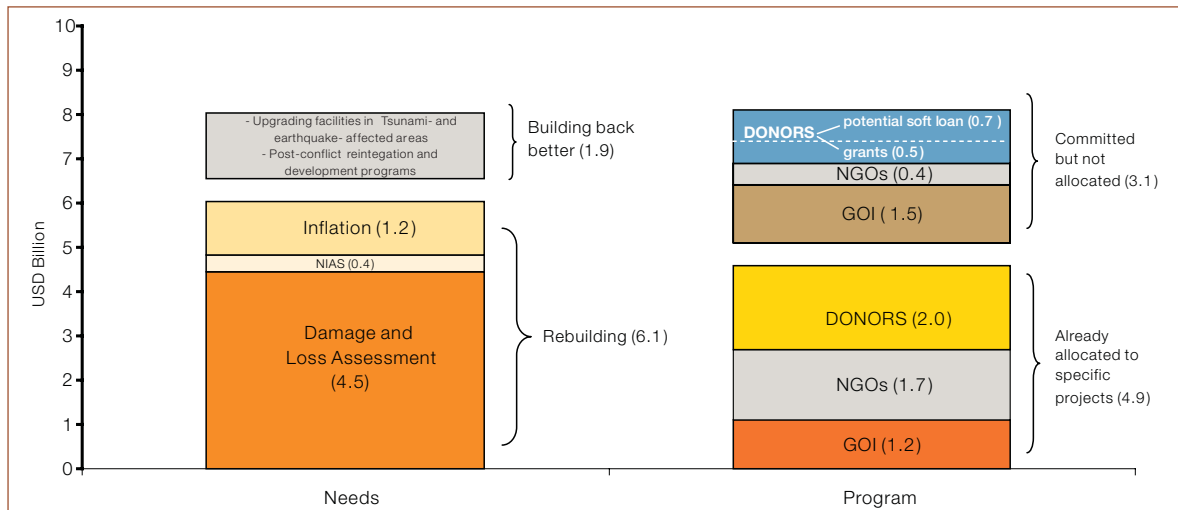
In the past 6 years, Aceh has experienced an unprecedented inflow of regular fiscal revenues, on top of which came the largest reconstruction program in the developing world. Aceh's high level of financial resources will remain unchanged in the years to come and, if anything, increase. Three factors explain the increase:

1. **Aceh has been among the main beneficiaries of decentralization.** Since 1999, Aceh's regular revenues, managed by the province and local governments, increased from Rp. 2.4 trillion in 1999 to 11.2 trillion in 2006. Several factors contributed to this enormous increase, including the transfer of responsibilities in 2001, Aceh's special autonomy status in 2002, and another stark increase in the General Allocation Fund (Dana Alokasi Umum, or DAU) in 2006.
2. From 2005–09, **spending on reconstruction** will almost double Aceh's regular expenditure level. The total reconstruction portfolio stands at approximately Rp 45 trillion, representing approximately 1500 projects being implemented by more than 250 institutions. Total spending on the reconstruction effort is expected to exceed Rp. 70 trillion by 2009.
3. Beginning in 2008, **the new Law on Governing Aceh** (Law 11/2006) will allocate an additional Rp. 4 trillion

through a “special autonomy fund” (*dana otsus*), which will total Rp. 5 trillion by 2011. With declining oil and gas revenues, the *dana otsus* is likely to become the second most important source of Aceh’s revenues, similar to the importance of special autonomy funds in Papua.

The rehabilitation and reconstruction funds provide Aceh with the opportunity to rebuild a better province. The physical damages and losses caused by the tsunami and the earthquake in Nias (March 28, 2005) are estimated at US\$4.9 billion, on top of which at least US\$1.2 billion needs to be added for inflation. By June 2006, US\$4.9 billion worth of projects and programs had been allocated to the reconstruction effort. An additional US\$3.1 billion have been pledged which will bring the total reconstruction program to US\$8 billion. With these additional funds, Aceh and Nias will have an opportunity to “build back better” and invest in projects and programs that will have a long-lasting impact on their economies and social fabric (figure 4).

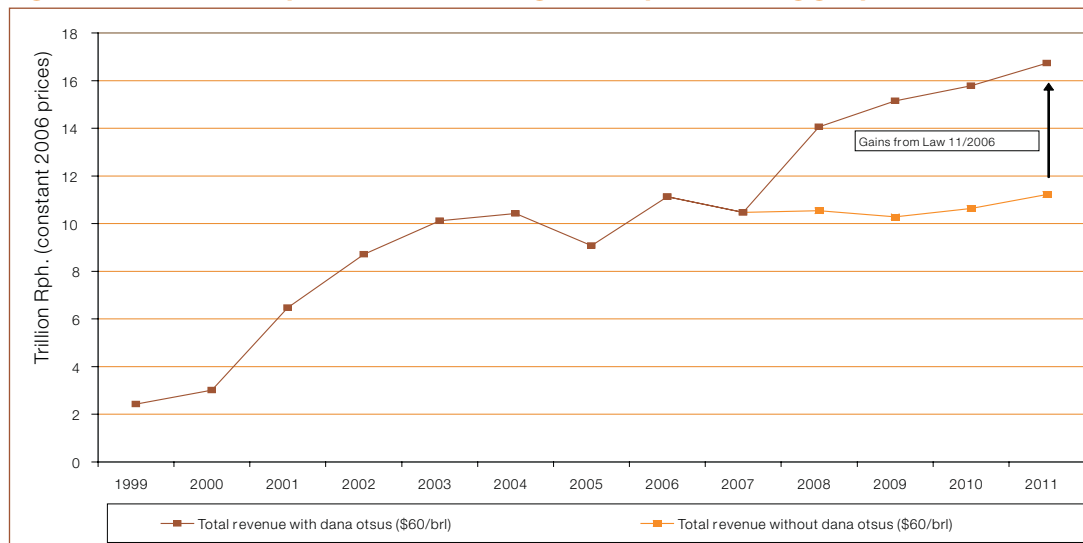
Figure 4. Reconstruction needs and commitments (US\$ billion, end-June 2006)



Sources: BRR/World Bank staff estimates.

Aceh’s fiscal revenues will increase further. The new Aceh law re-endorses the provision of the special autonomy fund. With it, Aceh’s revenues are expected to increase from the current Rp. 11.2 trillion to almost Rp. 16.7 trillion in 2011 (figure 5). The new special autonomy fund and a higher DAU-allocation until 2028 will more than compensate the partial decline of funds from natural resources due to depleting oil and gas reserves. The large allocation of resources for the next 20 years should translate into better provision of services as well as create a stronger productive sector.

Figure 5. New Aceh law provides substantial gains despite declining gas production



Source: World Bank staff estimates based on data from SIKD/MoF.

Due to the large inflow of resources after decentralization, total regional expenditure has risen sharply for both provincial and local governments. On average, regional governments in Aceh have been managing more than two-thirds of total public spending. Before decentralization, almost 60 percent of spending was carried out by the central government, leaving a limited role for regional governments to provide service delivery and regional development. Administrative costs of a growing number of local governments in Aceh are claiming a disproportionate share of these additional regional resources. Routine expenditures are now accounting for 60 percent of local governments' budgets.

Service Delivery

Aceh has the resources to fight poverty, but it has not yet made much progress. Paradoxically, once Aceh's revenues started to increase disproportionately in 2001, its poverty levels remained unchanged at 30 percent although the rest of Indonesia experienced a massive decline of poverty to below 20 percent. The conflict, which intensified in 2001 and 2002, contributed to these high poverty levels. Within Aceh, regions with high revenues are not exempt from poverty. Aceh Utara, both an oil and gas producing region and severely conflict affected, is the most extreme case. This district has both the largest fiscal resources and one of the highest poverty rates.

Aceh has not only a very high poverty rate but also very poor public services. In health and education, striking long-term structural problems outweigh the short-term challenges after the tsunami. Reconstruction has progressed well in these sectors. Most school facilities have been rehabilitated or are under reconstruction. However, fewer than half of elementary school facilities are well maintained, and the majority of teachers do not have the legally mandated qualification. Many of the midwives and teachers left the more insecure rural areas for urban centers, so one of the main challenges is to provide incentives for them to return to more remote areas.

Health

Local government spending on health has barely increased since 2002. The share of health expenditures spent on salaries continues to rise. Aceh has one of the highest rates of doctors and nurses in Indonesia and a large number of health care facilities. However, often staff is absent, electricity supply unreliable, running water rare, and necessary medication not available. Budgets for nonsalaried operational costs are very low, worsening poor health services. The government's focus is to improve or build facilities, due partly to the increasing number of districts that want to build new facilities, although for some facilities, use is too low to be sustainable.

Education

Aceh has sufficient teachers, but the gaps in coverage remain huge. Teachers favor urban over rural regions, creating serious gaps in rural regions. Rather than increasing the number of teachers, local governments should develop an appropriate system of incentives and sanctions that will place quality education within reach of all Acehnese. Although regional spending on education quadrupled in 2002, it has been falling since then. Most of it was consumed by routine expenditures (primarily teacher’s salaries), which account for 63 percent of total education expenditure. The poor state of education facilities and lack of materials in schools are the main problems. Aceh has the highest per capita education expenditures in Indonesia (Rp. 457,000 vs. national average of Rp. 196,000), making the focus on quality even more urgent.

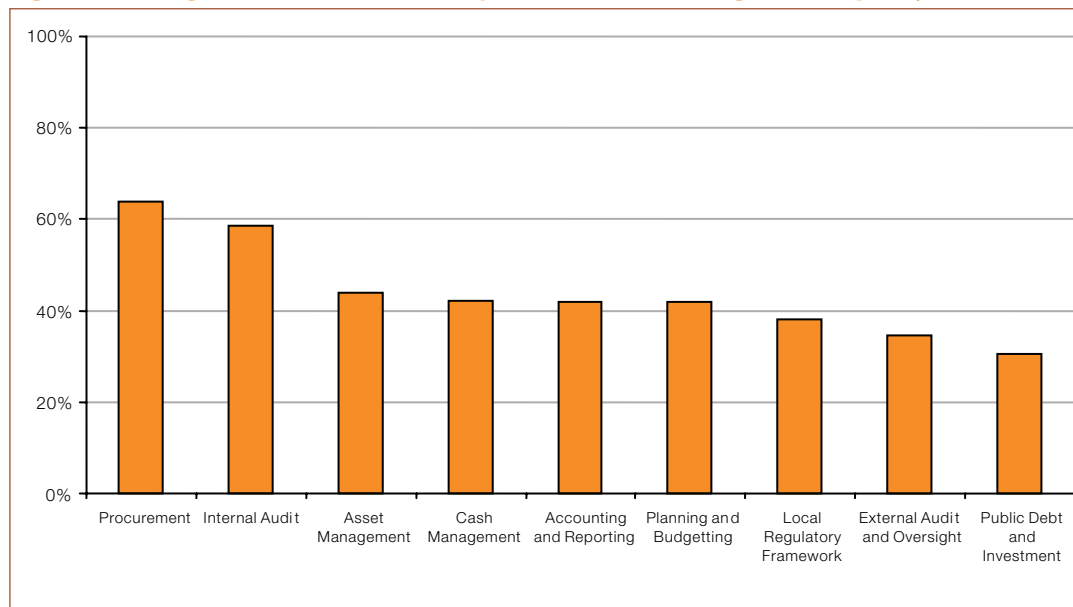
In infrastructure, the 2005 tsunami compounded the difficulties that had existed for a long time. However, in some subsectors, Aceh is almost on par with the national average. The household electrification rate and road density are higher than the national average, but household water connections, private sanitation, and irrigation infrastructure are well below national levels. Two-thirds of Acehnese households are connected to electricity, but blackouts are frequent in many areas in the province.

Infrastructure spending rose significantly after decentralization but has been declining since 2002. Salaries account for a large share of routine expenditure in the infrastructure budget, while operational and maintenance expenses represent only a marginal share. After the tsunami, many local governments further lowered their infrastructure investments in the expectation that reconstruction projects from central government, donors, and NGOs would take the lead.

Local Government Capacity to manage budget funds

In recent years, the role, responsibilities, and workload of local governments have increased dramatically. However, the skill mix and incentives for local officials to carry out their tasks has not kept pace with their increased responsibilities. A 2006 Public Financial Management (PFM) Survey in nine districts indicates that the average capacity in local governments is not sufficient to take on these new roles (figure 6). In some districts, particularly Nagan Raya and Aceh Jaya, PFM capacity is extremely weak.

Figure 6. Local governments have weak public financial management capacity



Source: Public Financial Management Survey, average score for 9 surveyed kab/kota (district/city), 2006.

Most local governments have difficulty managing the increasing flow of funds. Since decentralization, personnel spending has crowded out capital investment in public services. Development expenditures are concentrated on government apparatus, to the detriment of other areas for which it is more urgently needed. Contrary to the needs identified, local governments spend little on training, while a major share of their capital investment goes to buildings, vehicles, and equipment. The allocation of funds for general public administration needs to be scrutinized. A reorientation of expenditure toward building the capacity of existing staff is urgently needed.

Agenda for Implementation

Aceh's policy-makers can make many changes to better manage its vast resources. The three most important reforms relate to a (a) better allocation of resources, (b) better management of resources, and (c) better data analysis to inform allocation and management of resources.

1. Better Allocation of Resources

Development spending needs to be increased—not reduced. Provincial and local governments' abundant resources are the key to improve the lives of the Acehnese. Aceh's local and provincial governments have been among the main beneficiaries of decentralization and special autonomy. However, these governments have yet to fully participate in building a better future for Acehnese people. In 2005 most local governments cut the share of their development expenditures in response to additional funds from the Rehabilitation and Reconstruction Agency (BRR) and donors.

Spending on the government apparatus is too high. Local governments are devoting an increasing amount of their resources to bureaucracy, at the expense of development spending. Spending on government apparatus continued to increase even after the number of districts stabilized. This trend must be scrutinized. There is no indication that increased spending on government bureaucracy has resulted in better management of fiscal resources. Public spending should be devoted to development-related activities that improve service delivery and social welfare, and yield long-term economic and social benefits rather than bureaucracy.

Future spending by the central government on largely decentralized functions should be minimized. Even excluding reconstruction financing, the central government still contributes more than 30 percent to Aceh's investments. Most of these investments are on largely decentralized functions. Central government spending can be well targeted through earmarked grants (DAK). The focus can be lagging regions and activities related to national priorities and having large economies of scale.

Strategic (re-) allocation decisions with respect to the reconstruction funds should be made now. By June 2006, US\$4.9 billion reconstruction funds were allocated. At this still rather early stage of the reconstruction, the main sources of large-scale programmable funds are limited. The remaining financing gaps need to be urgently addressed. BRR will have the largest amount of flexible funds to address these gaps. The gaps are most significant in transport as well in the regions south of Moelaboh (Aceh Barat Daya, Aceh Selatan), around Lhoksumawe (Aceh Timur, Aceh Tamiang) and Nias.

2. Better Management of Resources

The capacity of local governments to manage their finances needs to be enhanced. According to the PFM survey, the capacity of local governments to manage fiscal resources is lowest in the areas of planning and budgeting, accounting and reporting, external audit, public debt management, and investments. Moreover, there are significant gaps in local government capacity across districts. For several indicators, some districts are shown to have an extremely low level of capacity. If the Acehnese are to benefit from increased financial resources in the region, the issue of capacity must be urgently addressed.



Local government planning and budgeting processes require significant improvement. Most local governments approve their budgets very late, often up to six months into the fiscal year. This delay in turn delays project implementation. To start implementing their projects at the beginning of each fiscal year, local governments must accelerate their budget approval processes. In addition, actual budgets often do not correspond to actual needs, particularly in the education and health sectors.

3. Better data Quality

There is an urgent need to improve data collection and processing. The lack of data and its low quality makes any programming and budgeting very difficult. Accurate data also is required for evidence-based policy-making, monitoring, and evaluation. Data collection and processing should be combined with identifying appropriate indicators, which can in turn inform policy-making and programming.

For reconstruction monitoring, labor intensive monitoring systems have proven superior to high-technology, self-entry-based information systems. The Recovery Aceh-Nias (RAN) Database system has not yet delivered any significant results, even on its key promise to track the money. The main reasons have been a lack of methodology to categorize funds, limited quality control and data analysis, and a too-sophisticated IT system that made it difficult to enter and to find core data. The only workable tracking system has a much more “low-tech” approach, based on a systematic follow-up with key institutions coupled with a strong emphasis on data analysis.