

ACEH PUBLIC EXPENDITURE ANALYSIS

SPENDING FOR RECONSTRUCTION AND POVERTY REDUCTION

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GLOSSARY OF TERMS

Acronyms and abbreviation

Adat	: Social custom or tradition
ADB	: Asian Development Bank
AMDAL	: (<i>Analisis Mengenai Dampak Lingkungan</i>) Environment Impact Permit
AMM	: Aceh Monitoring Mission
APBD	: (<i>Anggaran Pendapatan dan Belanja Daerah</i>) Regional Government Budget
APBN	: (<i>Anggaran Pendapatan dan Belanja Negara</i>) state budget
APEA	: Aceh Public Expenditure Analysis
AusAid	: Australian Agency for International Development
Bappeda	: (<i>Badan Perencanaan Pembangunan Daerah</i>) Regional Development Planning Agency
Bappenas	: (<i>Badan Perencanaan Pembangunan Nasional</i>) National Development Planning Agency
BAKORNAS	: (<i>Badan Koordinasi Nasional</i>) national disaster management board
BPK	: (<i>Badan Pemeriksa Keuangan</i>) national auditing agency
BPN	: (<i>Badan Pertanahan Nasional</i>) National Land Agency
BPR	: (<i>Bank Perkreditan Rakyat</i>) rural credit bank
BPHTB	: (<i>Bea Perolehan Hak atas Tanah dan Bangunan</i>) land and building transfer fee
BRA	: (<i>Badan Reintegrasi Aceh</i>) Reintegration Agency for Aceh
BRR	: (<i>Badan Rehabilitasi dan Rekonstruksi</i>) Rehabilitation and Reconstruction Agency
BPD	: (<i>Bank Pembangunan Daerah</i>) regional development bank
Bupati	: Head of District
BPS-SK:	
BQ	: (<i>Baitul Qiradh</i>) Syariah Financial Cooperative
Camat	: Head of Sub-district
CDA	: Community Driven Adjudication
CDD	: Community Driven Development
CFAN	: Coordination Forum for Aceh and Nias
CoHA	: Cessation of Hostilities Agreement
CoSA	: Committee on Security Arrangements
CPI	: Consumer Price Index
CSO	: Civil Society Organization
DAU	: (<i>Dana Alokasi Umum</i>) general allocation grants
DDR	: Disarmament Demobilization and Reintegration
Desa	: Village
DAK	: (<i>Dana Alokasi Khusus</i>) earmarked grant
Dana OTSUS	: (<i>Dana Otonomi Khusus</i>) special autonomy fund
Dinas	: Regional Sector Office
DIPA	: (<i>Daftar Isian Proyek Anggaran</i>) issuance of spending authority
DOM	: (<i>Daerah Operasi Militer</i>) military operational area
DPRD	: (<i>Dewan Perwakilan Rakyat Daerah</i>) Provincial House of Representative
ERTR	: Emergency Response and Transitional Recovery
ETESP	: Earthquake and Tsunami Emergency Support Project
FIRM	: Financial Intermediation and Mobilization
GAM	: (<i>Gerakan Aceh Merdeka</i>) Free Aceh Movement
GCF	: Gross Capital Formation
GDP	: Gross Domestic Product
GER	:
GeRAK	: (<i>Gerakan Rakyat Anti Korupsi</i>) People's Movement for Anti Corruption
GOI	: Government of Indonesia
GRDP	: Gross Regional Domestic Product

HDI	: Human Development Index
IAIN	: (<i>Institut Agama Islam Negeri</i>) Public Islamic Institute
ILO	: International Labor Organization
IMR	: Infant Mortality Rate
Inpres	: (<i>Instruksi Presiden</i>) Presidential Instruction
IOM	: International Organization for Migration
IRD	: International Relief and Development
JPK –Gakin	: (<i>Jaminan Pemeliharaan Kesehatan-Keluarga Miskin</i>) government health insurance for poor households
JPK-MM	: (<i>Jaminan Pemeliharaan Kesehatan-Masyarakat Miskin</i>) government health insurance for the poor
Kabupaten	: District
KDK	: (<i>Komite Darurat Kemiskinan</i>) emergency humanitarian committee
Kecamatan	: Sub District
Kelurahan	: Urban Village
Kepmen	: (<i>Keputusan Menteri</i>) Ministerial Decree
Keppres	: (<i>Keputusan Presiden</i>) Presidential Decision
KERAP	: An elected local committee that in charge and monitor reconstruction
Kesbanglimas	: (<i>Kesatuan Kebangsaan dan Perlindungan Masyarakat</i>) regional agency, in charge for social and political life in the community, previously known as Regional Social and Political Agency
Kota	: City (urban district)
LGSP	: Local Government Support Program
LOGA	: Law on Government in Aceh
MDTF	: Multi Donor Trust Fund
Mesjid	: Mosque
MoE	: Ministry of Environment
MoNE	: Ministry of National Education
MoRA	: Ministry of Religious Affair
MoU	: Memorandum of Understanding
MPW	: Ministry of Public Work
NAD	: (<i>Nangroe Aceh Darussalam</i>) formal name for Aceh Province
NBFI	: Non Bank Financial Institutions
NGO	: Non Governmental Organization
OCHA	: Office for the Coordinator of Humanitarian Affairs
PAD	: (<i>Pendapatan Asli Daerah</i>) own source revenue
PBB	: (<i>Pajak Bumi dan Bangunan</i>) Land and Building Tax
PDAM	: (<i>Perusahaan Daerah Air Minum</i>) local water supply enterprise
PEACH	: Public Expenditure Analysis Capacity Harmonization
Perpu	: (<i>Peraturan Pemerintah Pengganti Undang-undang</i>) regulation in lieu of law
Perda	: (<i>Peraturan Daerah</i>) Regional Regulation
Pesantren	: Islamic School
PFM	: Public Financial Management
PLN	: (<i>Perusahaan Listrik Negara</i>) the national electricity company
PMU	: Program Management Unit
PODES	: (<i>Potensi Desa</i>) BPS village potential statistics
Polindes	: (<i>Pos Persalinan Desa</i>) village maternity post
Posko	: (<i>Pos Koordinasi</i>) coordination post
Puskesmas	: (<i>Pusat Kesehatan Masyarakat</i>) Community health center at sub district level
Posyandu	: (<i>Pusat Pelayanan Terpadu</i>) integrated health services unit
Pustu	: (<i>Puskesmas Pembantu</i>) Sub-community Health Center
Qanun	: Islamic Regional Regulation (the term only used in Aceh)

RALAS	: Reconstruction for Aceh Land Administration Project
Renja KL	: (<i>Rencana Kerja Kementrian/Lembaga</i>) ministry work plan
Renstra	: (<i>Rencana Strategis</i>) strategic plan
Renstra KL	: (<i>Rencana Strategi Kementrian/Lembaga</i>) ministry strategic plan
Renstra SKPD	: (<i>Rencana strategis Satuan Kerja Perangkat Daerah</i>) dinas work plan budget
RKP	: (<i>Rencana Kerja Pemerintah</i>) government annual work plan
RKP-D	: (<i>Rencana Kerja Pemerintah Daerah</i>) regional government annual work plan
Rp	: (<i>Rupiah</i>) Indonesian's currency
SD	: (<i>Sekolah Dasar</i>) primary school
SDI	: Surface Distress Index
SDO	: (<i>Subsidi untuk Daerah Otonom</i>) Subsidy for Autonomous Region
SIKD	: (<i>Sistem Informasi Keuangan Daerah</i>) Regional Finance Information System
SE	: Small Enterprises
SME	: Small Medium Enterprise
SPADA	: Support for Poor and Disadvantage Area
Susenas	: (<i>Survei Sosial Ekonomi Nasional</i>) BPS national socio-economic survey
Syariah	: Islamic Law
UNDP	: United Nations Development Program
UNICEF	: United Nations Children's Fund
USAID	: United State Agency for International Development
WB	: World Bank
WBOJ	: World Bank Office Jakarta
Yoy	: year-on-year

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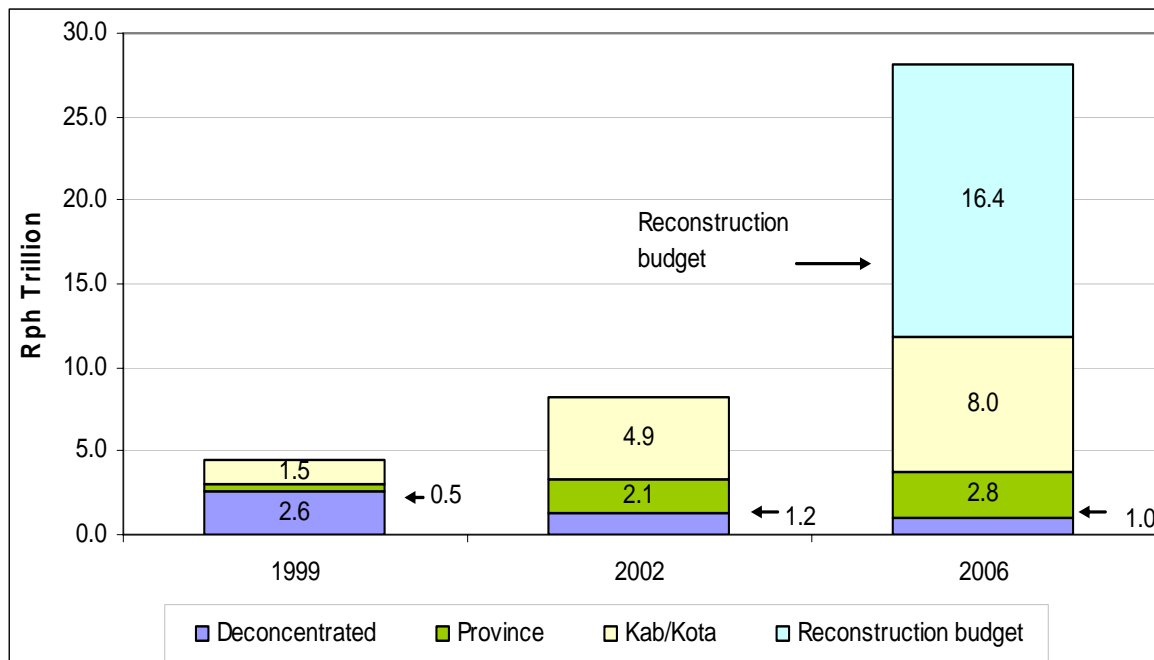
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EXECUTIVE SUMMARY

Aceh has seen an extreme increase in its fiscal resources. With Decentralization and Special Autonomy Aceh's revenues increased three-fold. The amount managed directly by the Acehese province and local governments increased five times. In addition, Aceh received an unprecedented amount of assistance from the Indonesian government and the international community following the December 2004 tsunami. In 2006, total funds flowing into Aceh are estimated at Rp. 28.2 trillion (US\$ 3.1 billion). Most of these resources come from the reconstruction program (Rp. 16.4 trillion) but regular financing is also increasing rapidly and is expected to reach Rp. 11.8 trillion in 2006 (Figure 1).

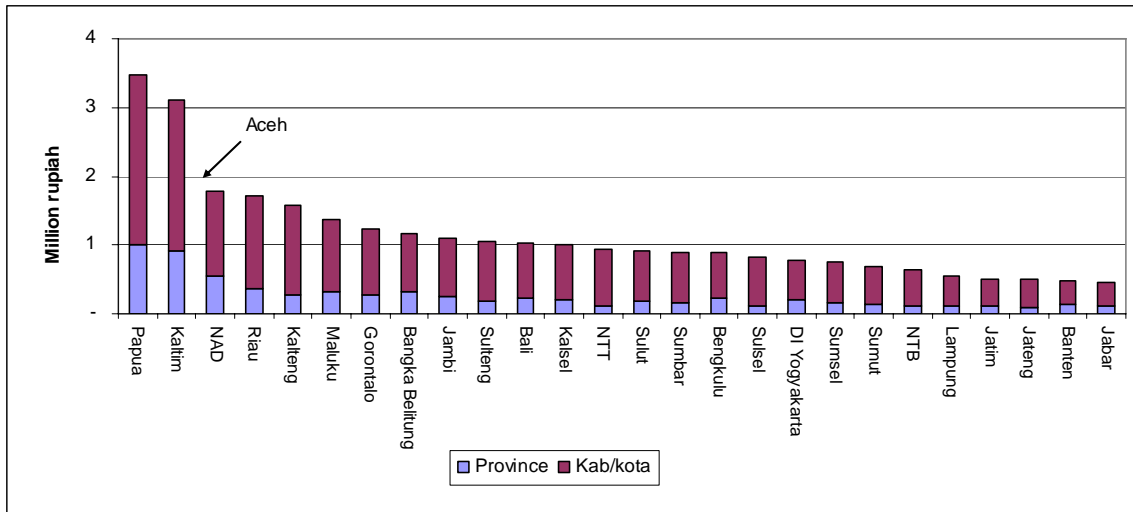
Figure 1: Aceh revenue pre- and post-decentralization, and after tsunami



Source: World Bank staff estimates (2005 constant prices) based on data from SIKD/MOF and BRR

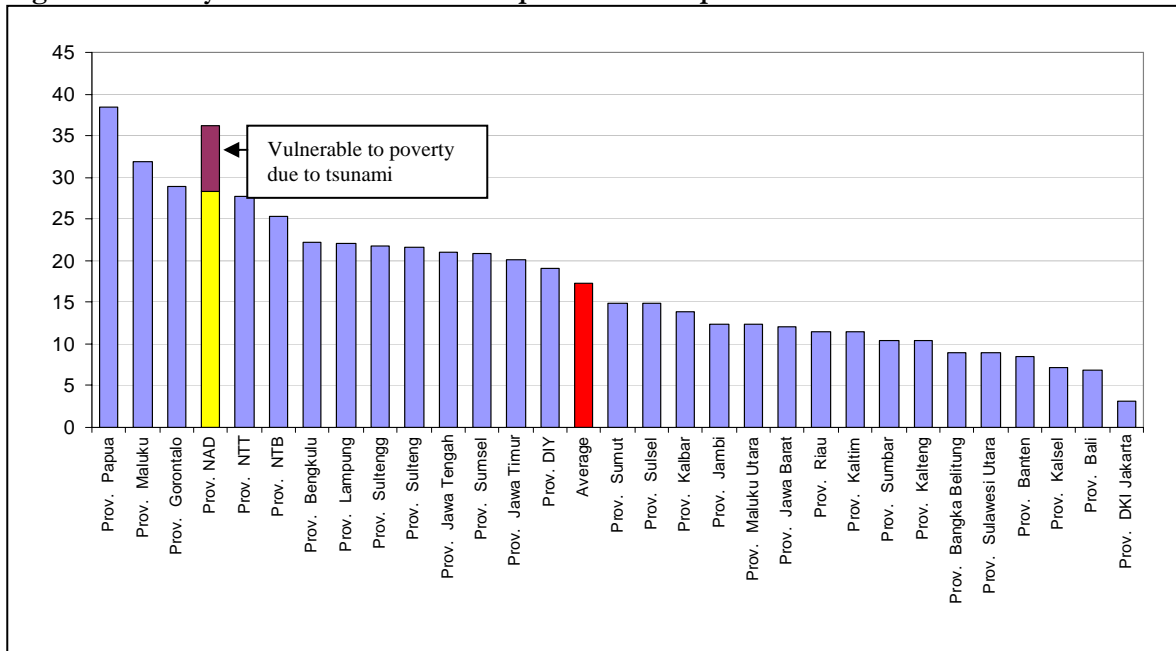
With this wealth of fiscal resources, Aceh has the opportunity to reduce high levels of poverty and improve public services. Aceh is the 3rd richest province in terms of public resources per capita (Figure 2), but at the same time it remains the 4th poorest province in Indonesia (Figure 3). In 2004, an estimated 1.2 million people in Aceh (28.5 percent of the total population) were living below the poverty line of Rp. 130,000 (about US\$ 14) per capita per month. The share of people living in absolute poverty in the region prior to the earthquake and tsunami was 28.5, and thus almost twice as high as Indonesia's average poverty rate (16.7 percent). With the tsunami, an additional 325,000 people have become vulnerable to falling below the poverty line.

Figure 2: Aceh's revenue per capita compared to other provinces



Source: SIKD/ Ministry of Finance, World Bank staff estimates based on 2004 APBD.

Figure 3: Poverty headcount in Aceh compared to other provinces



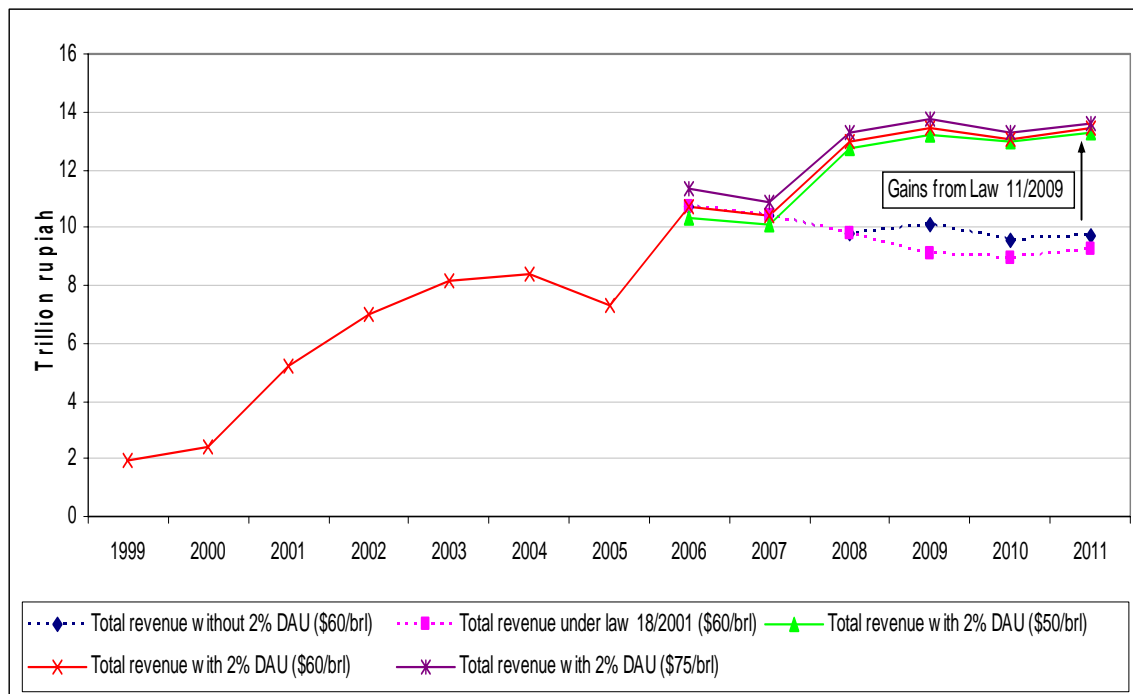
Source: BPS, 2004.

The large amount of resources can also help improve services in conflict affected-areas. The implementation of the Helsinki peace agreement – signed on August 15, 2005, – has been broadly on track and gives Aceh a chance to rebuild a peaceful society and regain economic prosperity through improved allocation of public resources and increased investments in the region. The 30-year conflict between the Government of Indonesia (GOI) and the Free Aceh Movement (GAM) claimed some 15,000 lives, dislocated several thousand families and caused massive destruction to public and private properties, and severely affected the region's economy. The conflict prevented the government from providing minimum public services in the areas worst affected by the conflict and robbed the regional economy of its vitality.

REVENUES AND EXPENDITURES

Aceh's fiscal position will only get stronger. The recently passed Law on Aceh Governance, Law 11/2006, introduces a special autonomy fund (Dana Otsus). In addition to rising regular transfers, Aceh's revenues are expected to increase from the current less than Rp. 11 trillion to almost Rp. 14 trillion (figure 4). This special autonomy fund and increasing DAU-allocations will more than compensate for the projected decline in oil and gas revenues. However, the amount of resources that Aceh's districts receive varies considerably.

Figure 4: Aceh Revenue Projection until 2011 (trillion Rp.)



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

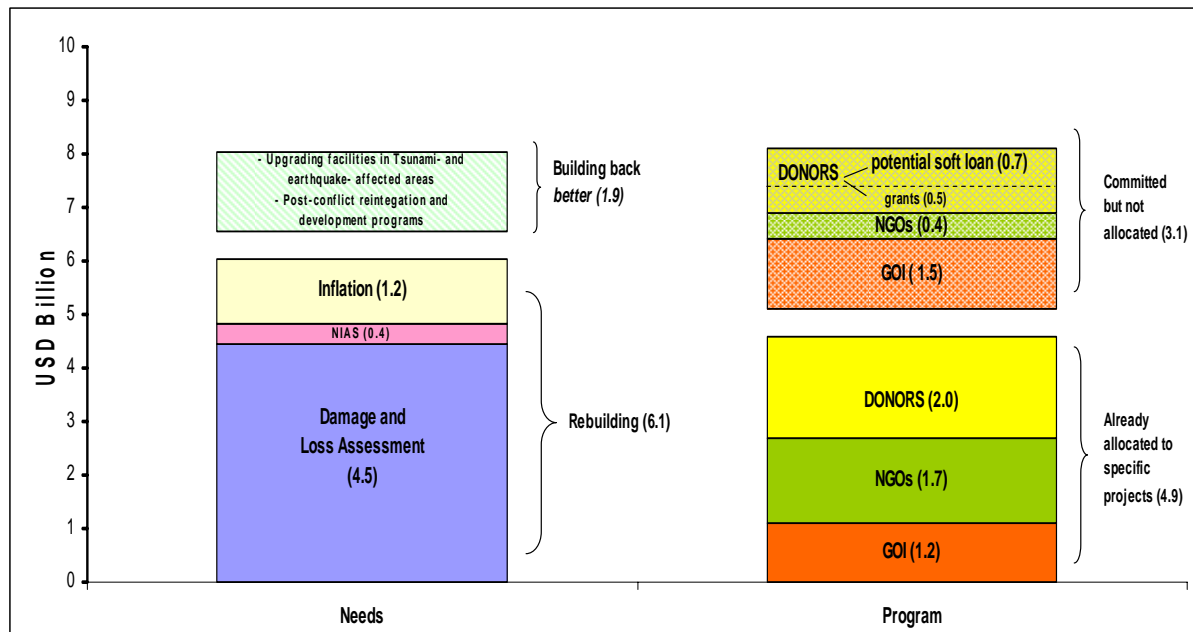
The most important source of revenues are the General Allocation Fund (DAU) and natural resources revenue sharing. Since 2002, these two sources of funding have accounted for 85 percent of total revenues. Own-source revenue is extremely low with only 4 percent of the total revenues. In the next years, funds from natural resources will decline but the new special autonomy fund and an increasing DAU-allocation will more than compensate this partial decline. Such a large allocation of resources for the next 20 years should translate into better provision of services as well as a stronger productive sector.

The rehabilitation and reconstructions funds provide Aceh with a chance to “build back better.”

The earthquake and tsunami caused immense social, economic, and environmental devastation to areas that were already poor. Thousands more people became vulnerable to poverty and dependent on food aid after the disaster. The physical damages and losses caused by the tsunami and earthquake in Nias, and including inflation, are estimated at US\$ 6.1 billion. Full recovery will take years. The calamity unleashed an unprecedented national and international response for emergency needs with the Indonesian Government, NGOs and donors making record reconstruction contributions. Aceh and Nias now represent the largest reconstruction program in the developing world. 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 5).

Figure 5: Reconstruction needs and commitments (US\$ billion, end-June 2006)



Source: BRR/World Bank staff estimates

SERVICE DELIVERY

Increased budget expenditures have yet to translate into concrete results on the ground. Aceh does not only have a very high poverty rate but also very poor public services. Vaccination rates among children remain below national average and more than 30 percent of the senior high school students fail the national exam. Aceh’s social indicators have failed to improve even after fiscal resources increased rapidly because Government expenditures have not been allocated effectively. Spending on the government apparatus and salaries has increased disproportionately while expenditures on health, education and infrastructure have almost been stagnant (less so on education).

Government spending on health has barely increased after special autonomy. Despite the increase in revenue, Aceh’s healthcare system remains woefully under-funded. Inadequate health care provision means that private contributions from households make up a large share of total health expenditures. Given the high poverty rates and increased vulnerability for many after the tsunami, unpredictable health expenditures can easily drive people into poverty. Although health care facilities are generally available, a lack of maintenance and absence of staff limit the services provided. There is a large focus on improving and building facilities, enhanced by the increasing number of districts, but construction should be linked to a needs assessment and an efficient use of resources. Proper mapping of health care facilities, its maintenance and the human resources required is important before deciding to build more health care facilities.

Aceh has a sufficient number of teachers but the quality of education is very poor. 54 percent of all villages in Aceh do not have a primary school. 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 for all Acehnese. The Province of Aceh has the highest per capita education expenditures in Indonesia (per capita spending of Rp. 457,000 vs. national average of Rp. 196,000), which makes current quality issues even more striking. More resources should be allocated for maintenance and equipment whereas teachers' salaries already take up too much of education expenditure.

Provincial and local governments need to invest in building their capacity to manage large infrastructure projects. Local and provincial governments will be responsible for most reconstruction infrastructural assets. Technical and institutional absorptive capacity constraints must be urgently addressed. Current spending patterns, with few funds being earmarked for capacity building and maintenance, are a cause of concern. Monitoring and evaluation systems should be strengthened to ensure a cost effective and sustainable infrastructure sector.

AN AGENDA FOR IMPLEMENTATION

Aceh's policy makers can make many changes to manage its vast resources better. The most important reforms relate to a (i) better allocation of resources, (ii) better management of resources, and (iii) 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 improving the lives of the Acehnese. Aceh's local and provincial governments have been among the main beneficiaries of decentralization and special autonomy, but they have yet to fully participate in building a better future for Acehnese people. In 2005, most local governments have been cutting the share of their development expenditures in anticipation of funds from BRR and donors.

Spending on the government apparatus needs to be kept on a leash. Local governments are devoting an increasing amount of their resources on 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 carefully 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. Aceh simply cannot afford to spend an increasing share of its public resources on bureaucracy.

Future spending by the central government on largely decentralized functions should not be encouraged. Despite a less significant role of central government in regional spending after decentralization, it still contributes more than 30 percent (excluding reconstruction financing) to development spending. The data indicate that the central government continues to spend on largely decentralized functions, which should not be the case given that regional government is supposed to have a better understanding of regional priorities. Central government spending can be well targeted through earmarked grants (DAK) with the focus on 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 are 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 by the Government. Important sectoral (transport) and geographical (Aceh Barat Daya, Aceh Selatan, Aceh Timur and Aceh Tamiang) gaps remain.

2. BETTER MANAGEMENT OF RESOURCES

The capacity of local governments to manage increasing fiscal flows must be enhanced. According to the Public Financial Management (PFM) survey conducted recently in nine of Aceh's districts, 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. In fact, on several indicators some districts are shown to have an extremely low level of capacity. The issue of capacity must be urgently addressed if the Acehnese are to benefit from increased financial resources in the region.

Local government planning and budgeting processes require significant improvement. Bottom-up budget planning and timely budget processes are needed to reach regional development targets and objectives. There are several examples in the education and health sectors of a mismatch between identified needs and allocation of resources. Key budget preparation and implementation issues that require attention include: (i) inequity between basic fund allocations and development outcomes across region; (ii) lack of correlation between short-term and long-term development plans, regional development program, strategic plan, and general policy objectives; (iii) poor targeting of public spending; and (iv) sectoral and geographical gaps.

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 is also required for evidence-based policy making, monitoring, and evaluation. Data collection and processing should be combined with identifying appropriate indicators that can in turn inform policy making and the programming.

For reconstruction monitoring, labor intensive monitoring systems have proven superior to a high-tech self entry based information systems. In Aceh, the Development Assistance Database (DAD) system has not yet delivered any significant results, even on its key promise to track the money, mainly due to (i) a lack of methodology (all projects are lumped together); (ii) limited quality control and data analysis; and (iii) IT-problems, as data has been difficult to enter and to find. The only workable tracking system is based on a systematic follow-up with key institutions coupled with a strong emphasis in data analysis..

1. THE ACEH CONTEXT: HISTORY, CONFLICT, NATURAL DISASTERS, ECONOMIC AND SOCIAL CONDITIONS

Historical Context

The Province of Aceh, known formally as Nanggroe Aceh Darussalam (NAD), is located on the northern tip of Sumatera. Surrounded by the crucial trade route, the Malacca Strait, to the north and east, the Province of North Sumatera in the south, and Indian Ocean in the west, the Province of Aceh covers an area of 57, 365 km² and has a population of about 4 million people. At present, Aceh consists of 17 municipalities (*kabupatens*) and 4 cities (*kotas*), with Banda Aceh as the capital of the province.

Islam came to Aceh as early as the 9th century. Indonesia's first Islamic kingdoms were powerful Acehese trading states. By the 1300's, the great kingdom of Samudra, located near present day Lhokseumawe, was renowned as a center for trade and Islamic study. Aceh's stature as a center of Islamic learning led to its nickname, the Veranda of Mecca. Syariah has been used as the basis of law for kingdoms in Aceh and is presently implemented in Aceh's administration system.

The kingdom of Aceh was founded in the early sixteenth century and rose to prominence after the 1511 conquest of Malacca by the Portuguese. Its golden age came in the early seventeenth century under Sultan Iskandar Mudah who made Aceh into the most important military and trading power in the region. Despite internal strife after the Sultan's death, by 1820, Aceh was again a powerful and wealthy kingdom supplying half the world's pepper. It maintained relations with foreign powers including the Ottoman Empire, France, Great Britain, and the United States; however its wealth attracted the attention of would-be colonizers. The Netherlands annexed Aceh in 1874 and the Acehese continued to fight a guerilla war that continued until 1912.

Left unoccupied after World War II, Aceh played a pivotal role supplying funds to the republican government during the struggle for independence. In recognition of its contributions to the Indonesian independence struggle, Aceh was made an autonomous region in 1949. Turbulence followed for the remainder of the Soekarno regime: the following year the newly autonomous region was incorporated into the province of North Sumatera leading to the first Acehese rebellion led by Daud Beureueh and Aceh's reinstatement as a province (1957) and autonomous region status in 1959. Greater autonomy, however, did not protect Aceh from the severe economic privation of the last years of Soekarno's reign.

After the upheaval of late Soekarno years, the Acehese welcomed the establishment of the New Order¹ but conditions in Aceh did not improve. The obvious richness of the province's natural resources on the one hand and a persistent poverty on the other hand exacerbated feelings of unequal treatment by the central government. The prolonged social and economic imbalances were not addressed by the central government and another rebellion/separatist movement known as the Free Aceh Movement (GAM) started in 1976 under the leadership of Hasan Tiro. This struggle between GOI and GAM would continue until 2005.

The Helsinki MoU offers great opportunity for Acehese to improve their communities economic performance, attain better living standards and move toward good governance system. The main point of the agreement is that Aceh is allowed to establish local political parties that are in line

¹ The New Order is a governmental period under the leadership of President Soeharto, which covers the period of 1966-1998.)

with national regulation. According to the Memorandum of Understanding (MoU), central government also agreed to provide Aceh with a larger share of revenue from natural resources and special allocation from DAU (Box 1.1). The Law implementing such provisions is the Law on Governance of Aceh (11/2006) passed in August 2006. The fiscal arrangements under previous and the new law are presented in Table 1.1.

Box 1: Some of Key Features of the Helsinki MoU between the Government of Indonesia (GOI) and the Free Aceh Movement (GAM)/ Law on Government of Aceh (LOGA), Law 11/2006

- **Administrative/ Politics**
 - The right to use regional symbols including a flag, a crest and a hymn
 - The right to establish local political party
 - Protection of local culture
 - Establishment of commission for Truth and Reconciliation
- **Fiscal & Economy**
 - The right to set interest rates different from those set by the Central Bank of Indonesia
 - Retain 70 percent of revenue from oil & gas and hydrocarbon and other natural resources
 - Transparency in revenue sharing allocation, audited by foreign auditor
 - Additional revenue from 2% of national DAU allocation for 15 years and 1% for 5 last years.

In addition to nationwide decentralization, Aceh was granted **Special Autonomy status under Law 18/2001**. This law seeks to address some crucial issues relating to inequality and poor economic situation in Aceh and to offer greater autonomy for Aceh in managing its resources and governance functions. There are four key features of Aceh's special autonomy: i) large share of retained revenue from oil and gas, ii) direct election of governor and head of local government (Bupati/Walikota)², and iii) implementation of Syari'ah/Islamic Law. Law 18/2001 puts more emphasis on the provincial level, and thus somewhat contradicts with Law 22/1999 which places more importance on the local government level.

Box 2: Key features of Aceh's Special Autonomy

- **Administrative**
 - Direct election of Governor and the head of local government (Bupati/Walikota)
 - Implementation of Syari'ah Law and establishment of Syari'ah Court
 - Protection of local culture and establishment of *Wali Nanggro*e (traditional culture body)
 - Protection of regional symbol and anthem
- **Fiscal**
 - High revenue sharing from oil and gas (70 percent)
 - 30 percent of revenue sharing should be allocated to education
 - Inclusion of *Zakat* as own-source revenue

Source: Law 18/2001

² This is envisioned to be the first direct election at the local level in Indonesia before Law 32/2004 concerning local governance was passed which specifies the direct election of head of local government to be implemented nationally.

Table 1. 1: Evolution of intergovernmental fiscal arrangements for Aceh

Revenue Sharing	Law 33/2004 (national allocation)		Law 18/2001 (Special Autonomy)		Law 11/2006 on Government of Aceh	
	Central	Province	Central	Province	Central	Province
Tax sharing						
Land and Building Tax (PBB)	10	90	10	90	10	90
Land and Building Transfer Fee (BPHTB)	20	80	20	80	20	80
Personal Income Tax (PPH)	80	20	80	20	80	20
Non-Tax Sharing						
Forestry	20	80	20	80	20	80
Mining	20	80	20	80	20	80
Fishery	20	80	20	80	20	80
Geothermal	20	80	20	80	20	80
Oil (non-tax) net revenue	85	15	30	70	30	70
LNG (non-tax)	70	30	30	70	30	70
Additional Revenue from total national DAU allocation						2

Conflict and its Impact on Development

Impact and cost of the conflict

The conflict between GAM and GOI had different stages. The first stage had no significant impact in Aceh and GAM held little political or military clout. The resurgence of conflict in 1989 saw a better trained and armed GAM. In response, the government transformed Aceh into a military zone (Daerah Operasi Militer - DOM). The transformation of Aceh into a military zone resulted in the deployment of a sizeable contingent of military and police forces. These forces remained in the province until their pull-out in late 2005 as a result of the MoU. The last phase is the most destructive of all, with discontent with the central government in Jakarta spread even to urban centers. From 1999 until the signing of the peace accord, armed encounters between GAM and the military became frequent. A World Bank Study, based on newspaper monitoring of conflicts, indicates that while the encounters between GAM and the military decreased after the tsunami, the war continued. Many experts and observers of Aceh agree that the conflict was driven mainly by two issues: difficult center-periphery relations between Jakarta and Aceh; and a sense of exclusion or exploitation in Aceh in the enjoyment of benefits of its natural resources (Table 1.2).

Table 1. 2: Stages of the conflict and casualties

Phase	I: 1976 – 1979	II: 1989 – 1991	III: 1999 – 2005			
Key Events	Founding of GAM	DOM	Humanitarian Pause: 2000 – 2001	COHA ³ : Dec 2002 – May 2003	Martial Law / State of Emergency May 2003 – May 2005	MoU Aug. 2005
Casualties	100	2,000 – 10,000	5,000			
GAM Strength	25 – 200	200 – 750	15,000 – 27,000			

³ COHA - Cessation of Hostilities Framework Agreement.

Conflict undoubtedly had a pronounced effect on Aceh. However, an accurate measure of the cost and impact of the Aceh conflict is difficult to assemble. In most cases, data have not been kept in a systematic way. In instances where information is available, accuracy becomes an issue. Some NGOs who kept some data on the victims of the conflict have lost them to the tsunami. In other cases, data are of a sensitive nature, which makes it difficult to secure them. However, stories from the press and interviews done in previous studies provide some illustration of the impact and cost of conflict. The impact and cost of conflict can be categorized into the following categories: (i) loss of lives; (ii) social impact; (iii) absence of functioning government; (iv) economic impact; (v) fiscal impact of the military operation.

Loss of Lives

The greatest impact of the conflict is on the lives lost. Estimates place this number at around 15,000 over 30 years. Human rights organizations and the newspapers regularly reported casualties due to the conflict even during the period of the Cessation of Hostilities Framework Agreement (COHA).

Social Impact

Poverty worsened during the period of conflict. In 1996, there were an estimated 491,800 (12.7 percent) poor in Aceh. This went up to 602,100 persons (14.8 percent) in 1999 and increased to 1.2 million (30 percent of the population) in 2002. The negative impact of the 1997 financial crisis on poverty levels was exacerbated in Aceh by the lasting conflict.

The education system was a special and purposeful target. In many cases, schools were used as temporary military encampments in their pursuit of GAM. The military also claim that GAM used schools as temporary bases. Schools were thus target of both conflicting parties. On some accounts, 60 teachers were killed and 200 assaulted between 1998 and 2002. During the DOM and martial law years, 527 schools and 122 official residences of teachers were burned or destroyed. In the first half of 2003, some 880 schools were reported as destroyed or damaged.⁴ As a result, the school system in many parts of Aceh closed down.

Absence of functioning government

At the height of GAM's strength a large portion of Aceh was under GAM influence or control⁵. Only district capitals and cities were safe. GAM's strategy was to disable local governments and to replace these institutions by GAM / Acehnese institutions. GAM is said to have been performing functions of government in many areas – tax collection, performing and registering marriages, issuance of licenses, etc. When GAM called for a boycott of the 1999 elections only 1.4 percent of the electorate in North Aceh and 11 percent in East Aceh turned out.⁶

Statements from both government and GAM seem to indicate that government was paralyzed in parts of Aceh at the height of the 3rd phase of GAM. At least in its stronghold in parts of Pidie, North Aceh, and East Aceh, local government was hardly operating. Government employees failed to appear for work for fear of being attacked. The Governor of Aceh in 2001 was quoted to have said that only 1/6th of Aceh's budget for 2001 had been spent by the middle of the year because of the conflict, and most of it, for law enforcement.⁷

⁴ Schulze, 2004.

⁵ Schulze, K, International Crisis Group.

⁶ Aspinall, 2003.

⁷ Aspinall, 2005.

Economic Impact

As in many cases of severe conflict, the impact on the economy was immense; operations closed and unemployment rose. During the last phase of the conflict, the people of Aceh experienced even heightened economic hardship with the worsening of the security situation. Investors withdrew and businesses, especially around the area of the gas fields, closed down or reduced production. In East and North Aceh plantations of palm oil stopped operations in 2003.⁸ Income from fisheries went down because fishermen were not allowed to go out to sea without a permit. The East-West Center, citing military sources at the height of the conflict, wrote that more than 350,000 people were unemployed and this figure did not take into account the fisheries and farming sector.⁹

The economy overall was stagnant. In 1990, Aceh contributed 3.6 percent to Indonesia's GDP. This fell to 2.2 percent in 2001 at the height of the conflict, mainly due to the drop in contribution from the oil and gas fields.¹⁰

Private and public properties were destroyed and damaged. A World Bank study¹¹ cites incidents of moving 7,000 people from five villages at the height of the conflict. While many have returned, some remain in barracks or temporary shelter. In many cases, the houses that villagers abandoned have been destroyed. A World Bank survey of needs and aspirations of GAM returnees and communities receiving them indicate widespread destruction.

Fiscal impact of the military operation

Several accounts of the conflict point to substantial government fiscal outlays, especially during the martial law years.¹² In the early 90's, there were only 6,000 troops in Aceh. Weeks before breakdown of the talks between GOI and GAM, that the army's strength in Aceh had been increased to about 30,000 and the police to 12,000.¹³ The ratio of military personnel to population increased from 1:570 in the early 1990s to 1:80 or 12.5 for every 1,000 population at the height of the conflict. The national ratio is 1:1,000.¹⁴ Data on the number of troops withdrawn after the MoU suggests there were a little over 50,000 troops and police in Aceh at the time of the peace agreement.

Government financed the operations largely from Central government funds. Provincial funds were used to augment national government resources and to fund the social welfare requirements (temporary shelter, food, etc. for evacuated population). Between 2002 and 2005, some 55,000 persons were assisted by the government in the form of social payments (*dijayat*) as victims of the conflict.¹⁵ The government spent close to US\$ 12 million to cover these expenses.

Peace process

The Helsinki MoU is, so far, the most promising instrument for peace in Aceh. Previous attempts at peace ended in more bloody struggles between GAM and government military forces (TNI). The

⁸ Sukma, R. 2004.

⁹ Ibid.

¹⁰ Ibid. Production in the gas fields began in 1977. The boom from the fields resulted in the development of other industries in fertilizers and chemicals.

¹¹ Barron, 2005.

¹² Official data on how much the thirty year conflict cost is not readily available.

¹³ Aspinall, E. 2005.

¹⁴ Analysis: Indonesia's military under scrutiny (1999) BBC News, Asia-Pacific, November 1999.

¹⁵ Data from Kesbanglimas, NAD.

current MoU has held the peace and promises to be the key to finally ending the struggle of GAM for independence.

Key economic provisions of the MoU include:

- Granting the province the right to set interest rates different from the one set by the Central Bank and raise funds using external loans (Box 1.1).
- Permanently granting 70 percent of the revenue from hydrocarbon deposits to the Province.
- While not in the MoU, the Law on the governance of Aceh, in accordance with the MoU, provides for a special allocation of 2 percent of total DAU pool.

The MoU also grants benefits to persons affected by the conflict. Farming lands, employment, social security and compensation are provided to former GAM and victims of the conflict. The process of awarding benefits started in October 2005 with the distribution of Rp. 1 million to every demobilized combatant. As of date, the government has released funds equivalent to US\$ 20 million. More funds are expected from the government for fiscal year 2006, at least. Some US\$ 60 million has been allocated for 2006 by the national government.

One demonstrable effect of the peace is the reduction in the government spending as military presence in Aceh was significantly cut. By the end of 2005, government reduced the number of military and police in Aceh to 23,800 (14,700 military and 9,100 police). While still high, this is almost half of the number at the height of the conflict. The number of troops withdrawn consists of 31,680 personnel.

In most places former GAM combatants and supporters have returned to their villages without incidents. Significant number of troops has pulled out of Aceh. The surrender of arms was completed on schedule. People in the villages have expressed optimism and hope over the potential that the peace will bring. An urgent agenda is the re-integration of former combatants. The Government of Indonesia and various donors are providing support to the reintegration program under the MoU.

In February of 2006, the Governor of Aceh established the *Badan Reintegrasi Aceh (BRA)*. BRA is expected to become the main body to coordinate government and donor post-conflict programs. The agency has started processing proposals from GAM and conflict affected persons. Funds for these proposals will be funded from the allocation of Rp. 200 billion provided by the Indonesian government for 2005 and Rp. 600 billion for 2006.

Challenges

Some major challenges remain. These include:

Combatants. A major problem is the situation of combatants. The MoU provides for benefits for 3,000 combatants. On the ground, people know there are many more than 3,000. The number also does not include support staff of the GAM army, widows and orphans. A World Bank study¹⁶ on the needs of returnees indicates there is variation in aspirations. There is also an indication that 30 percent of returnees do not simply want to go back to old professions, but prefer to explore new ones. This makes reintegration programming more challenging.

¹⁶ The GAM Reintegration Needs Assessment states that almost 30 percent of respondents wish to change profession / occupation and 23 percent are not sure of what they wish to do.

Internally Displaced People (IDPs). At the height of the conflict, several villagers left their homes voluntarily or forcibly. Some of these displaced persons are still living in temporary shelters in Central Aceh. Their needs include economic support, housing, health and training. However, no systematic effort has yet been developed to address their situation.

Affected communities. Communities have welcomed the peace and are expecting that prosperity will immediately ensue. The conflict has inflicted damage to receiving communities and they have a fair expectation that some re-construction or dividend from the peace process will be forthcoming. Providing benefits to GAM and militia alone will risk the creation of a rift that may result in another tension or conflict.

Short and Medium Term Priorities:

Livelihood support is urgent. Livelihood alternatives for former combatants need to be provided very soon. Since their return starting September 2005, many have remained idle and are starting to become burdens to their families and communities. As of February 2006, only 25 percent of former GAM has started to work.¹⁷ Among the reasons cited for not working are lack of opportunity, skills and capital. Of these, capital (92 percent of respondents) is the priority. Some productive means of replacing activities and incomes while they were rebels have to be provided. While the government has allocated resources, these resources are not sufficient or are not the right mix of interventions. Other priorities would be to provide housing to returnees as well as health and mental health assistance to victims of the conflict.

Transitional support to returnees and IDPs is also required. In most cases, returnees and IDPs are returning to their villages with nothing but the shirts on their back. Some short term cash assistance to help them stand on their feet is necessary.

Managing the tensions of the reintegration program is important. There are still tensions in communities greatly affected by the conflict, particularly in areas where GAM and militias were both operating.

Longer Term Priorities:

Longer term development of Aceh and freeing its people from the bonds of poverty are the long-term agenda of the province. As a start, the significant resources of government should be free of corruption. Transparent and accountable governance is a key challenge in Aceh. When urgency is required, and accountabilities are weak, this is an even bigger challenge.

Aceh needs some catching up in its development outcomes. The destruction brought about by conflict in Aceh and the negative impact of the conflict on human development indicators require special attention for Aceh to catch up with the rest of the country.

People of Aceh are watching the implementation of the Law on Government in Aceh (LOGA). The LOGA is not simply a GAM agenda but an agenda developed by all people of Aceh. Careful consideration of the passed Law is needed to ensure that the legislation will not erode the gains of peace, similar to what happened after the Darul Islam rebellion of the 1950s.

¹⁷ GAM Reintegration Needs Assessment (2006) World Bank Indonesia

December 26th, 2004 Earthquake and Tsunami – Impact and Reconstruction Progress¹⁸

On December 26, 2004, an earthquake struck 150 km off the coast of Aceh. Shortly after a tsunami wave hit Aceh and within minutes it swept clean an 800 km coastal strip of Aceh. Some 170,000 people perished, and about 500,000 were displaced from their homes.

The natural disaster caused immense social, economic and environmental devastation to areas that were already poor, while sparking unprecedented emergency support. Even before the tsunami, about a third of the population of Aceh lived in poverty. Thousands more became vulnerable to poverty and dependent on food aid after the disaster. The calamity unleashed an unprecedented national and international response for emergency needs, with NGOs and donors making record reconstruction funding contributions.

The physical damage and losses caused by natural disaster have been estimated at US\$4.9 billion. Productive sectors alone received estimated losses of US\$1.2 billion. More than half of this was in the fisheries sector and the rest was divided between farming and manufacturing. Cash-for-work, financed by many donors and NGOs, has played a vital role in providing safety nets and revitalizing the economy. These programs are now being phased out, as more housing construction projects and other regular employment activities are being launched. Post tsunami, prices in the province have increased more sharply than nationwide. The price hike was particularly noticeable in Banda Aceh, where year-on-year inflation in December 2005 reached 41 percent.

After a slow start, the pace of reconstruction has picked up markedly since September 2005. Faster than expected progress has been achieved in getting children back to school, restoring the health care network, replacing fishing boats, and restoring farmland and fishing ponds. Progress is also visible in the crucial housings sector. About 47,500 houses are reported to have been completed or nearing completion by end-April (Table 1.3). Each month, about 3,500 – 5,000 houses are now being built. BRR has set an ambitious target of building 78,000 new houses in 2006, a target that is achievable only if the pace of construction accelerates further.

Tabel 1.3: Reconstruction progress indicators (as of April 2006)

<i>Indicators</i>	<i>Damage/Need</i>	<i>Recovery</i>	<i>Source</i>
Housing	120,000	47,489	UN habitat
Schools	2,006	260	BRR Survey
Teachers	2,500	2,400	BRR
Health Facilities	127	113	BRR
Roads	3,000	490	BRR
Bridges	120	41	BRR
Sea ports	14	2 (complete)	BRR
Airports	11	5	BRR
Fishing Boat	7,000	6,160	BRR
Fish Ponds	20,000	7,111	BRR Survey
Rice Fields and plantation	60,000	37,926	BRR

Source: BRR

Many needs are still not met. Transitional shelter, in particular, remains a severe problem. About 15,000 to 20,000 families remain in tents and another 25,000 to 30,000 families remain in barracks. The

¹⁸ This section represents an updated summary of the report: “Aceh and Nias one year after the Tsunami: The Recovery Effort and Way Forward” (BRR and international partners), December 2005.

lack of adequate transport facilities along Aceh's west coast exacerbates the difficulties in delivering reconstruction material to underserved areas. Also livelihoods remain a severe concern. Particularly, women face a 21 percent unemployment rate (50 percent higher than the national average for women). The unemployment rate for men is much lower but still significant at 7 percent, and risks increasing again once construction subsides.

Despite the scale of destruction, Aceh now has the opportunity to transform itself from an isolated and conflict affected region of Indonesia to a well-developed province and an important economic hub for the country. The challenge is to “build back better”, not only in terms of physical infrastructure, but also in terms of using the available resources for the well-being of the province's people. In order to do so, Aceh and Nias need to overcome long-term structural problems to continue growing and alleviate poverty.

Local governments are not yet full participants in their own reconstruction and should play a more important role. Aceh's local and provincial governments have been among the main beneficiaries of decentralization. With increased transfers from the central government, coupled with higher revenues from oil and gas, Aceh's regions will be able to spend more than US\$ 1 billion in 2006 in regular programs, in addition to the existing reconstruction projects.¹⁹ However, in 2005, local governments have actually been *cutting* the share of their capital expenditures in response to the tsunami (from about 50 percent before the tsunami to 42-45 percent after the tsunami), anticipating substitution from BRR and donors. The larger share and absolute volume of spending on a growing local government apparatus at the expense of development spending is worrisome. Another critical issue is a widely perceived lack of capacity on part of local governments to effectively utilize the growing public resources.

It will be critical to increase local governments' contribution to the reconstruction process. Local governments have a large amount of untapped resources: more than US\$ 5 billion dollars in total revenues over 2006-2009 if the oil price stays at current levels. Most importantly, provincial and local governments will also be in charge of all reconstruction infrastructures once the BRR-mandate expires in 2009. It will be critical to engage local governments now in any new large-scale infrastructure projects. The use of a matching funds scheme (such as the new MDF Infrastructure Financing Facility) can present a good opportunity to increase engagement of local governments in infrastructure projects. The 2007 budget process will provide an important signal of the province's and local government's readiness to play a stronger role in the reconstruction process. Monitoring and evaluating local government spending will be important for ensuring that public funds are properly spent.

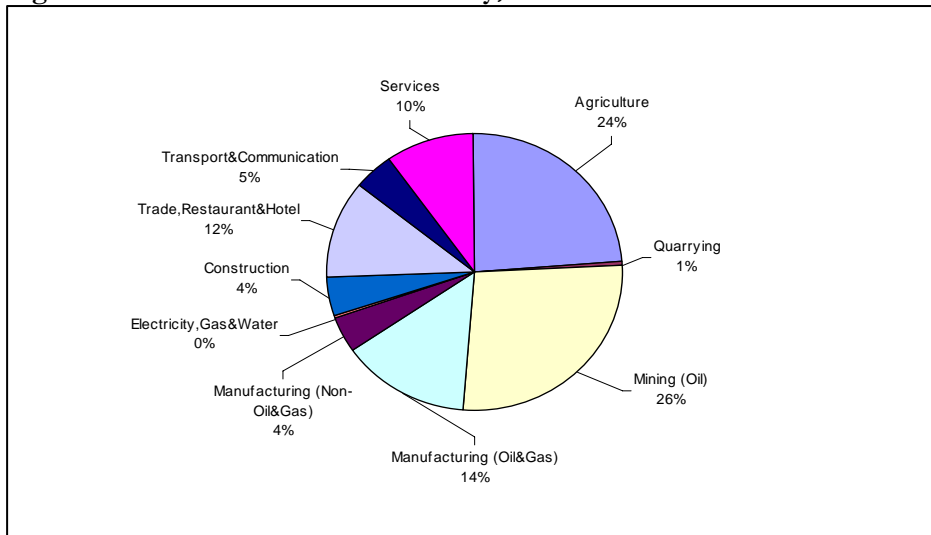
¹⁹ Financing of the reconstruction program is discussed in detail in Chapter 5.

Aceh's Economy

Structure of Aceh's Economy

The economy of Aceh relies heavily on the production of oil and natural gas, which accounts for about 40 percent of the province's GDP, but employs less than 10 percent of the workforce. The oil/gas producing *kecamatan* are Aceh Timur, Aceh Utara, and Aceh Tamiang. Aceh Utara contributes 80 percent of the overall oil and gas production. Agriculture on the contrary accounts for 24 percent of the province's GDP (Figure 1.1), but employs more than half of the workforce.

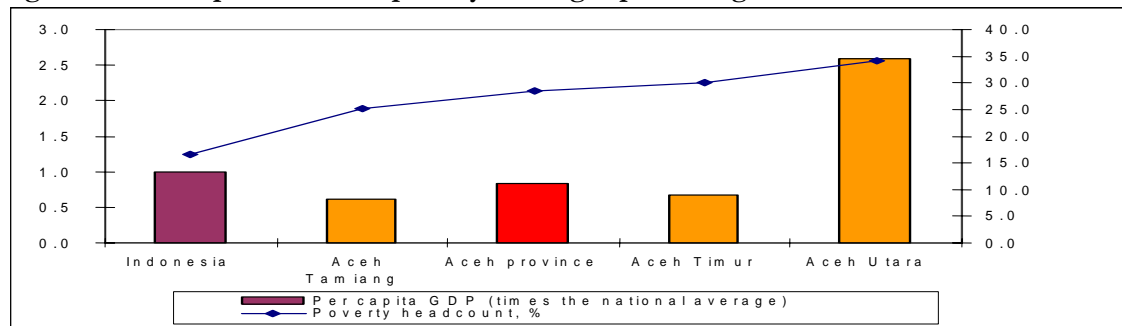
Figure 1.1: Structure of Aceh's economy, 2004



Source: BPS, 2004.

Historically, the oil/gas sector had very little positive impact on economic well-being of ordinary Acehnese. The majority of proceeds from natural resource revenue sharing were retained by the central government and the resources available to the province were allocated far from optimal.²⁰ For instance, Aceh Utara, with a per capita GDP 2.6 times the national average, had a poverty headcount of 34.2 percent, which is twice the national average (Figure 1.2).

Figure 1.2: Per capita GDP and poverty in oil/gas producing districts, 2004



Source: BPS, World Bank Staff calculations

²⁰ There are hopes that the decentralization and the Special Autonomy Law, which stipulates higher revenue sharing for the province, will change this situation. But that will depend on how well the available resources will be spent.

Gross capital formation (as percent of GDP) is low in Aceh, thus negatively affecting the growth potential. Aceh province has the lowest gross capital formation (GCF) among provinces in Sumatera and Java (Table 1.4). Even though in the period of 2001-2004 the capital formation in Aceh increased at an average of 22.16 percent annually, its ratio to GDP is still very low at 7.6 percent compared to 21.8 percent for Indonesia overall.

Tabel 1.4: Gross Capital Formation (GCF) in Aceh compared to provinces in Sumatera and Java, 1996 - 2004

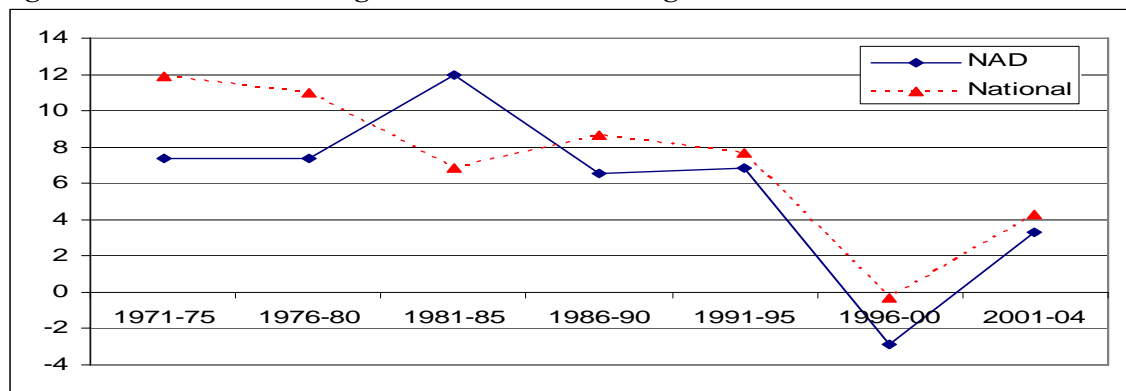
No	Province	Annual growth rate of GCF (%)			Ratio of GCF to GDP (%)		
		96-97	98-00	04-Jan	1996	2001	2004
1	Aceh	10.00	-8.87	22.16	11.35	7.64	7.59
2	Sumatera Utara	-6.00	-3.37	13.71	28.20	15.57	17.40
3	Sumatera Barat	7.83	-12.10	3.17	25.67	19.75	18.06
4	Riau	9.72	1.85	4.95	23.98	21.47	26.29
5	Jambi	1.49	-12.80	9.10	30.44	14.72	14.24
6	Sumatera Selatan	5.32	-4.60	8.78	32.73	18.67	18.73
7	K.Bangka Belitung	-	-	12.74	-	16.44	17.42
8	Bengkulu	-25.00	-10.50	6.26	30.63	8.22	8.18
9	Lampung	4.91	-11.50	4.30	35.93	17.72	16.05
10	DKI Jakarta	3.21	-12.10	4.28	48.23	34.48	40.20
11	Jawa Barat	-18.87	-17.30	6.01	27.07	15.32	15.64
12	Banten	-	-	11.59	-	19.96	20.53
13	Jawa Tengah	-7.32	-10.20	6.32	22.78	16.15	16.85
14	D.I. Yogyakarta	1.05	-3.31	16.87	27.59	25.04	29.02
15	Jawa Timur	5.44	-12.80	4.25	29.46	18.54	18.10
	INDONESIA	-0.86	-8.75	6.31	30.60	20.26	21.81

Source: BPS, Jakarta (reprocessed).

Aceh's economic growth and per capita GDP

The growth rate of Aceh's economy has been lagging behind national average growth rates since the 1970s, except for a short period of time in the early 1980s. Aceh, as the rest of Indonesia, was hit hard by the 1997-98 financial crisis, which resulted in negative growth rates for four consecutive years. Since 2001 Aceh's economy has started to recover (Figure 1.3).

Figure 1.3: Aceh's economic growth vs. national average

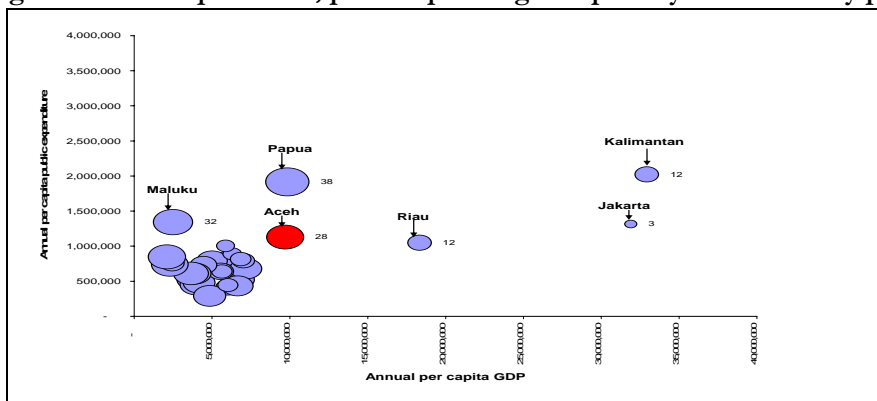


Source: BPS.

The main reason for relative (compared to the rest of Indonesia) stagnation in Aceh is the longstanding conflict that has robbed the region's economy of its vitality. However, there are also many structural problems that have led to poor economic outcomes, such as insufficient diversification of the economy, lack of modernization, and remoteness of many areas from markets.²¹

Despite relative stagnation for a long period of time, Aceh is still amongst the richest provinces in Indonesia in per capita GDP. At the same time, Aceh has one of the highest poverty headcounts. As of 2004 Aceh's annual per capita GDP was Rp. 9.8 million, or about US\$ 1,090,²² ranking Aceh as the 5th richest province, but with the 3rd highest poverty headcount rate (Figure 1.4). The fact that two of the richest provinces in terms of per capita GDP (Aceh and Papua) are two of the poorest should be cause for concern. High per capita GDP as a result of natural resources exploitation in both Aceh and Papua has not necessarily benefited the poor in the regions.

Figure 1.4: Per capita GDP, public spending and poverty headcount by province

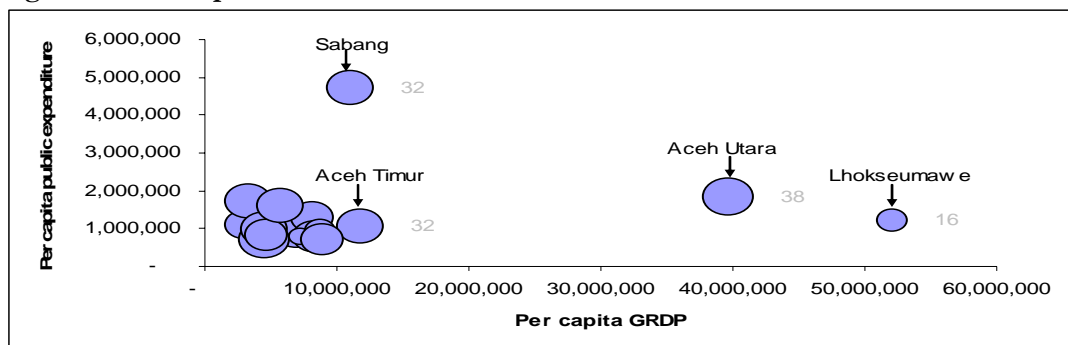


Source: BPS.

Notes: The size of the bubbles represents poverty headcount rates, with the number besides it giving the poverty headcount.

There is a substantial variation in per capita GDP among Aceh's districts (*kecamatan/kota*). For instance, in Aceh Tenggara and Simeulue annual per capita GDPs are Rp. 3.1 and 3.3 million, respectively, compared to Aceh's average of Rp. 11 million (Figure 1.5).

Figure 1.5: Per capita GRDP



Notes: The size of the bubbles represents poverty headcount rates.

Source: Ministry of Finance, BPS, and World Bank staff calculations.

²¹ These aspects are discussed in a greater detail below.

²² Using the 2004 monthly average exchange rate of Rp. 8,985/US\$ 1.

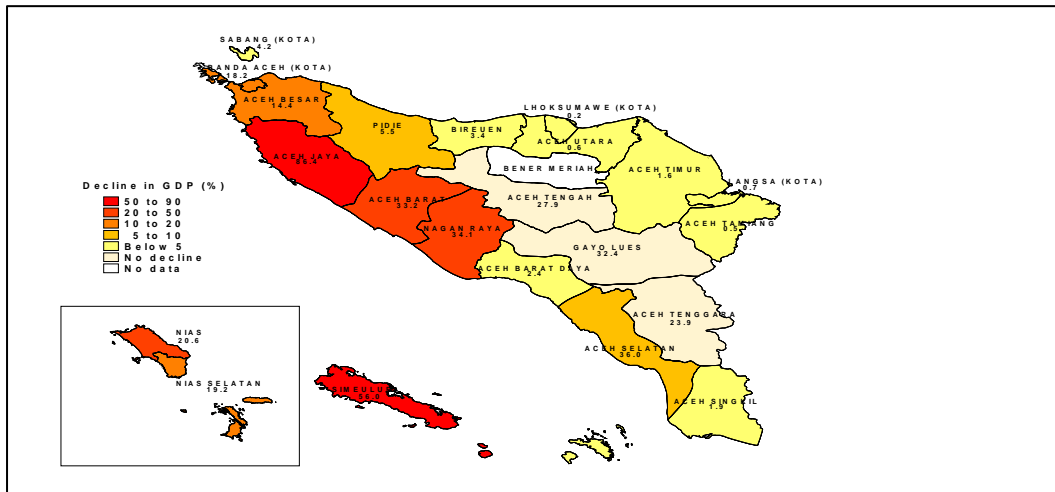
Figure 1.6: Spatial distribution of per capita GDP in Aceh, 2004



Source: BPS data, mapped by World Bank staff.

Aceh's economy was severely affected by the Dec. 2004 earthquake and tsunami. The estimated impact suggests an economic decline of about 5 percent in 2005.²³ This aggregate impact on Aceh's economy conceals substantial estimated variation across *kabupaten* - from about 0.5 percent decline in Aceh Utara and Aceh Tamiang to more than 50 percent decline in Simeuleu and Aceh Jaya (Figure 1.7).²⁴

Figure 1.7: Estimated decline in 2005 GDP (%), by kabupaten



Source: World Bank staff estimates

²³ The actual 2005 GDP numbers are not available.

²⁴ On the methodology of estimating the impact of tsunami on GDP at local government level see "Aceh and Nias one year after the tsunami: The recovery effort and way forward", December 2005.

Aceh's economy – challenges and opportunities

The short-term economic prospects will be largely determined by activities related to the reconstruction phase, such as the construction boom. The longer-term economic potential of the region, and thus revenue-generating capacity, will depend on addressing the following issues:

Modernizing economy

Traditional sectors, such as fisheries, have a good potential if developed and modernized. For instance, Acehese fishermen still rely on small boats which have very limited catching capacity. The Exclusive Economic Zone (EEZ), which covers 238,807 sq. km. of sea area, has an estimated potential stock of fish 1,000 times larger than available stock in the territorial area, but is only accessible to large boats. Providing larger vessels, rather than just replacing the small boats destroyed, would substantially boost output. The agriculture sector also has a good potential if developed beyond subsistence farming (although large-scale plantations do exist, they are not the core of agricultural production). Large areas of suitable land are not yet utilized (estimated at 293,000 hectares) allowing expansion of modern farming.

Diversifying exports

In Aceh, 98 percent of exports value is derived from liquefied natural gas and condensate, only 2 percent is derived from agricultural and industrial products. Among agricultural products, coffee is the prime export commodity - 98 percent of total agricultural export. Diversification of exports presents a good opportunity to boost growth, but is not an easy task. For instance, exporting agricultural products like cocoa, vanilla and patchouli, is constrained by small-scale production and volatile output.

Maximizing the employment opportunities during the reconstruction and beyond

Currently an estimated 318,000 people in Aceh are seeking or available for work. Large-scale construction projects are gathering steam and an estimated 200,000 workers will be needed during the peak of reconstruction efforts in mid-2006, be it either in housing, local public infrastructure or major provincial infrastructure. To maximize the employment gains for Aceh's population, several policies are needed. According to ILO, these include: (i) organize the labor market (brokering demand and supply for employment); (ii) enhance people's employability by providing skills and vocational training; (iii) employ people through labor-intensive infrastructure investments. This should be complemented by strategies to promote self-employment and enterprise development.

Developing processing units at the district level

Small farmers in Aceh usually sell raw products as the processing facilities are not available locally. Thus, they do not benefit from sharing the substantial value added that usually results from processing. Local producers are also poorly organized and are not informed about the full market potential of their products. The development of the local processing business would benefit local producers.

Ensuring that economic recovery is environmentally sustainable

Economic development must include sound environmental policies. Forestry areas in Aceh comprise 74.6 percent of total territory size. These tropical rain forests, rich with wood and wildlife, are severely endangered. Twenty companies have been granted licenses to explore approximately 1.6 million hectares of what has been classified as production forest. The increased demand for wood, driven by tsunami reconstruction needs, have already resulted in illegal exploitation of forests.

Exploring investment opportunities

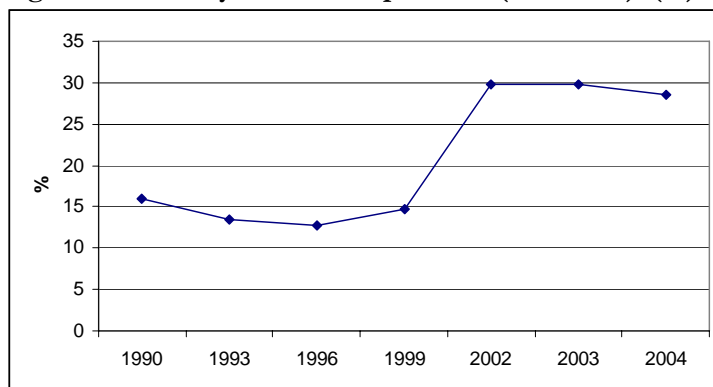
A transparent and stable business climate could increase investor interest for the numerous investment opportunities in the region. Potential sectors include free trade and free port zone Sabang, fishing and fishery industry, tourism, hotel and restaurant business, molding industry, animal husbandry industry, development of plantations and recreational forests, etc.

Poverty and Social Conditions

Poverty

Poverty was widespread in the Aceh Province even before the December 26, 2004 earthquake and tsunami. In 2004, an estimated 1.2 million people (28.5 percent of total population) in Aceh were living below the poverty line of Rp. 129,615 (about US\$ 14) per capita per month.²⁵ In fact, the share of people living in absolute poverty in the region has been almost twice as high as that in Indonesia overall (16.7 percent), making Aceh one of the poorest provinces.

Figure 1.8: Poverty trend Aceh province (1990-2004), (%)



Source: BPS

The December 26, 2004 tsunami has further exacerbated the poverty situation in the region. An estimated additional 325,000 people in Aceh are vulnerable to poverty. It is important to bear in mind, though, that the estimated increase in poverty does not take into account the mitigating impact of food aid, cash-for-work programs, and other mechanisms of lifting people's welfare.²⁶ The estimated increase in poverty is also likely to be temporary rather than permanent.

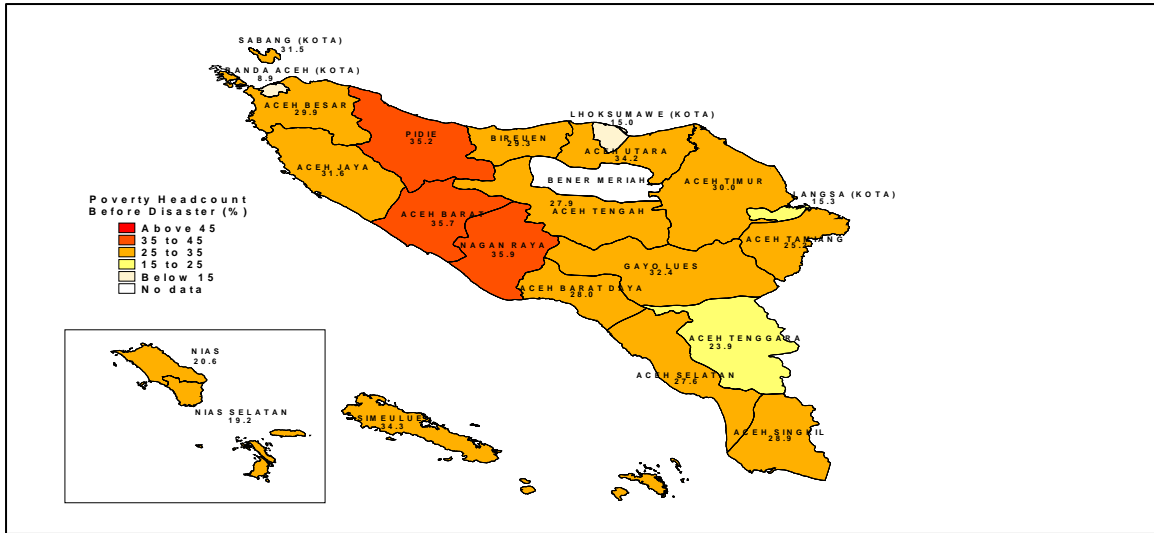
There has been a significant spatial variation in poverty rates across districts of Aceh. This variation has become even more pronounced due to the impact of tsunami. In the most affected districts more than 50 percent of population is likely to be living in poverty (Figure 1.9).

²⁵ The poverty line is grounded in the concept of consumption. It represents the monetary value of the typical food basket that provides 2100 calories per capita per day plus the necessary non-food expenditures.

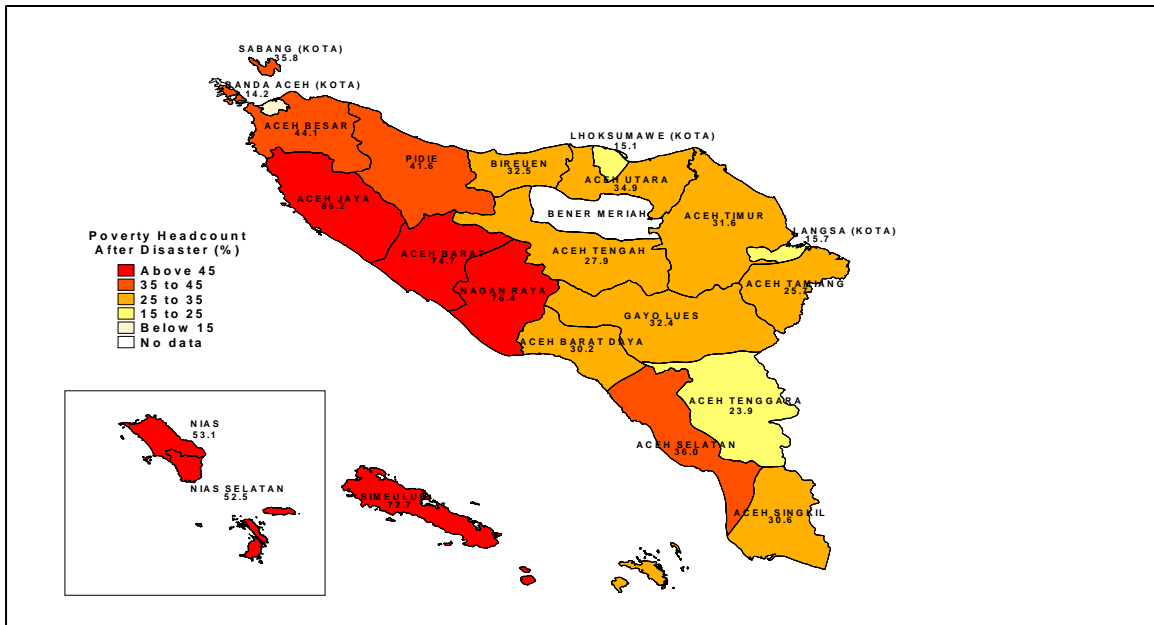
²⁶ On the methodology of estimating the poverty impact of tsunami see "Aceh and Nias One Year after the Tsunami: The Recovery Effort and Way Forward." (2005).

Figure 1.9: Poverty headcount across Aceh's districts, (%)

Panel A. Poverty headcount before the disaster



Panel B. Poverty headcount after the disaster

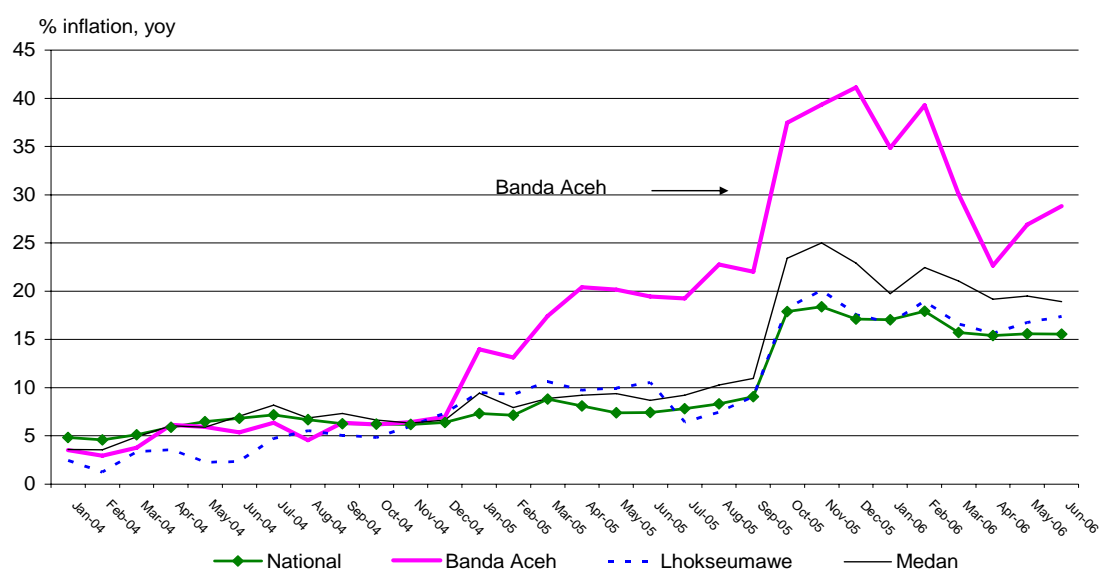


Source: BPS (actual 2004 data) and World Bank staff (estimates of post-disaster poverty rates).

Inflation

Substantially increased costs of living will affect the purchasing power of Aceh's population. Since the tsunami, prices in the affected regions have increased more sharply than the national average. The most dramatic increase has been in Banda Aceh. Year-on-year inflation in December 2005 reached 41 percent in Banda Aceh, 23 percent in Medan, and 18 percent in Lokseumawe, compared to 17 percent nationwide (Figure 1.10).

Figure 1.10: CPI trends in Banda Aceh and other sites



Source: BPS, World Bank staff calculations

Many of Aceh's households could potentially benefit from the fact that the reconstruction phase pushed up the wages of construction workers, but rising inflation could neutralize these benefits. In 2005 wages increased by at least 40-50 percent across all categories of construction workers. However, the net effect is not clear as the prices of consumer goods have also increased. Excessive wage inflation will dent Aceh's competitiveness with Indonesia and abroad after the construction boom. Inflation is not something that can easily be changed, but monitoring of prices and consumption patterns is necessary to understand the impact on living standards.

Livelihoods

Fisheries, agriculture, and small enterprises have traditionally been the key pillars supporting the livelihoods of Aceh's population. However, these sectors are facing a number of challenges related to the impact of natural disasters and the changing structure of the economy. Importantly, restoring livelihoods is more than rebuilding physical assets. While the replacement of assets is of high importance, the challenge is to provide comprehensive livelihood support for sustainable recovery of the affected communities.

The restoration and development of livelihoods should take place with an understanding of current and future needs and resource base. During the years prior to the tsunami there had been a significant shift in the workforce back to the agriculture and fisheries sectors as urban and service-based industries declined. If the underlying factors that caused the sectoral composition of the economy to change are not addressed, there will be a significant impact once resources allocated to reconstruction start to decline.

Pressure to quickly restore the asset base resulted in inadequate attention to quality. To take an example of the fisheries sector, providers have aimed to deliver as many boats as soon as possible, resulting in the delivery of many low cost, smaller boats. Lack of consultation and coordination with local fishermen, and poor quality of construction, has resulted in many of the delivered boats being abandoned due to their unsuitability to local conditions.

Agriculture and fisheries are in urgent need to be modernized. Even before the disaster, both sectors were characterized by a large number of small farmers and fishermen producing mainly for their own consumption or for the immediate local markets, with processing and packaging mainly done outside the region. There is a need to modernize both sectors through new technologies, finance, and business development services, and by encouraging a greater scale of production.

Creating Jobs

The impact of the tsunami on employment has been less severe than initially expected, but it has led to major changes in the composition and structure of the workforce. While there was a rise in unemployment in the immediate aftermath of the disaster, labor force participation has recovered rapidly. The participation of adult males in the labor force has returned to pre-tsunami levels, while the participation of women and youths (aged 15-24) has grown substantially. These previously untapped labor sources could contribute to faster economic growth and recovery. The increasing number of adolescents seeking for work instead of enrolling in schools decreases their opportunities for training and education, which would allow them to get better paid jobs in the long term.

The reconstruction needs have resulted in a construction boom, opening up the job market recently. Construction work in Aceh will be in range of US\$100- \$150 million per month range for the two coming years, compared to less than US\$10 million per month in 2003. To meet this demand, ILO estimates that about 200,000 skilled workers (carpenters, bricklayers, etc.) will be required, as well as a significant number of unskilled workers. In addition, the construction boom will create a large secondary demand for goods and services.

Still the construction boom will not provide sufficient jobs to get rid of unemployment. The latest post-disaster census shows that currently nearly 20 per cent of the labor force (more than 300,000 people) are actively seeking work or are available for work. The highest rates were in the 15-24 age group, where nearly 25 per cent were searching for work. The development of the employability of the local people through skills training is a key priority. Skills training must be demand-driven and linked to jobs in the market, with a particular focus on short-cycle training for workers certain to be engaged

2. PUBLIC FUND FLOWS, BUDGET PROCESSES AND BUDGET FORMATS

Public Fund Flows

Aceh, like other regions in Indonesia, receives funds from local own-source revenue (PAD), intergovernmental transfer, deconcentration funds from the central government and funds from provincial government. Local own-source revenue is generated by the region itself, mostly from local taxes and levies. Intergovernmental transfers are public funds that provide a vertical and horizontal dimension of transfers; vertical transfers redistribute revenue between central and regional governments²⁷, whereas horizontal transfers redistribute amongst district governments.

The DAU (Dana Alokasi Umum) has become the main source of revenue in Aceh after the decentralized system was introduced in 2001. Along with revenue sharing and DAK, DAU replaced the previous intergovernmental transfer of SDO (Subsidy for Autonomous Region) and INPRES (Presidential Instruction). The transfers consist of revenue sharing, general allocation fund (DAU), and specific allocation fund (DAK). The flow of transfers from central government to regional governments in terms of revenue sharing, DAU and DAK is laid out in Figure 2.1

Revenue Sharing

Revenue sharing is tax and non-tax revenue from natural resources shared between the central and regional governments. The goal of revenue sharing is to reduce vertical imbalances between the central and regional governments. Law 33/2004 is the primary document²⁸ governing central/regional fiscal balance. It stipulates the percentage of revenue to be divided between the center and the regions as well as the distribution process—funds are transferred directly to regional governments' accounts.

As a special autonomy region, Aceh receives additional revenue sharing under the Aceh Government Law 11/2006. This law grants Aceh additional shares from its oil and gas revenues, along with to the standard national allocation of sharing from tax and non-tax revenues. Additional legislation governing this revenue distribution arrangement comes in the form of Aceh regional regulation *Qanun* 4/2002.²⁹ The *Qanun* describes the transfer process of revenue sharing including land and building taxes (PBB) and land and building transfer fees (BPHTB). These funds are transferred directly to provincial and local governments, while revenue sharing of personal income tax and natural resources are transferred by the center to the province, and afterwards the province is responsible for transferring it to local government.

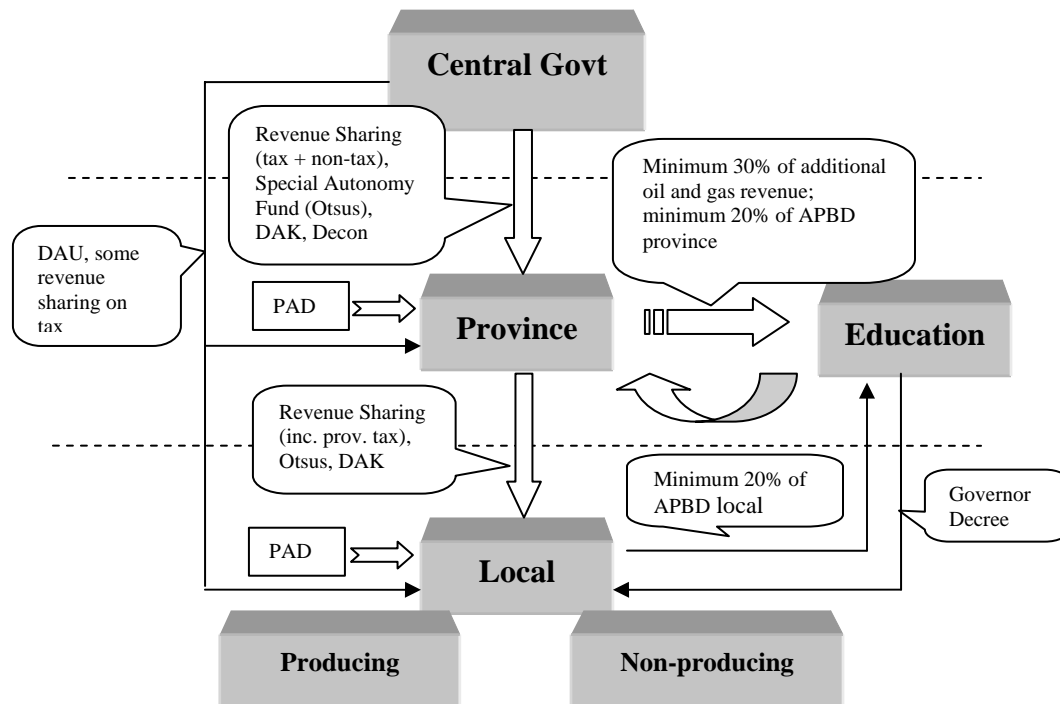
The Law also stipulates that a minimum of 30 percent of the additional revenue sharing received by regional governments go toward education. *Qanun* 4/2002 guides the transfer between province and local government. In addition, the law also stipulates that the remaining 70 percent of additional revenue sharing from oil and gas be allocated for development programs at the provincial and local government levels.

²⁷ Regional governments consist of provincial and local (local government) governments.

²⁸ Ministerial Decree KMK No. 344/2001 is also key in implementing revenue sharing.

²⁹ Regional regulations are called *Perda*, *Peraturan Daerah*, throughout most of Indonesia. Aceh, due to clauses in the Special Autonomy legislation calls its regional regulations *Qanun*.

Figure 2.1 Flow of funds in Aceh



Source: Law 11/2006, Qanun 4/2002.

Tax sharing

The tax-revenue share between the central and regional governments varies per tax. The corresponding share between the center and regions is 10-81 percent for land and building tax (PBB)³⁰, 20-80 percent for land and building transfer fee (BPHTB), and 80-20 percent for personal income tax (Table 2.1).

The general allocation arrangement between regional governments is 20 percent for the province and 80 percent for local government, with the exception of income tax. Personal income tax sharing is 40 percent for province and 60 percent for local government. A Gubernatorial Decree regulates distribution of personal income tax revenue shares to local governments based on such factors as population, area, etc.

Non-tax (natural resources) sharing

The general, the central and regional government for non-tax revenue is 20-80 percent, oil and gas revenues are two important exceptions. Regions receive higher percentages of oil, gas and reforestation revenues. Most significant for Aceh are oil and gas allocation, which are 85-15 and 70-30, respectively. The special autonomy legislation gives Aceh an additional 55 percent for oil and 40 percent gas, thus Aceh receives 70 percent of oil and gas revenues³¹.

³⁰ For PBB, the regions have 90 percent share, however 9 percent of it is allocated for administration fee.

³¹ Law 33/2004 stipulates that until 2009, the oil and gas revenue shares between the center and regions are 85-15 and 70-30 for oil and gas revenues, respectively. Starting in 2009, the shares of oil and gas retained by the center will

Table 2.1: Revenue sharing arrangements and the special autonomy fund of Aceh

Revenue Sharing	Central Government	Sub-national	Province	All <i>Kabupaten</i> / <i>Kota</i>	Producing <i>Kabupaten</i> / <i>Kota</i>	Non Producing Local government
Tax sharing						
Land and Building Tax (PBB)	10	81	16.2	64.8		
Land and Building Transfer Fee (BPHTB)	20	80	16	64		
Personal Income Tax (PPh)	80	20	8	12		
<i>(provide the list of major taxes)</i>						
Non-Tax Sharing						
Forestry: Land-rent (IHPH)	20	80	16	64		
Forestry: Resource-rent (PSDH)	20	80	16	64	32	32
Reforestation	60	40			40	
Mining: Land-rent	20	80	16	64		
Mining: Royalty	20	80	16	64	32	32
Fishery	20	80		80		
Oil (non-tax) net revenue**	30	15	3	12	6	6
		55	22	33	13.75	19.25
LNG (non-tax)	30	30	6	24	12	12
		40	16	24	10	14
Geothermal	20	80	16	64	32	32
Other tax sharing (province's tax revenue)						
Motor vehicle tax, water vehicle tax, motor/water vehicle ownership charges		100	70	30		
Motor vehicle fuel tax, water (ground and surface) utilization tax		100	30	70		

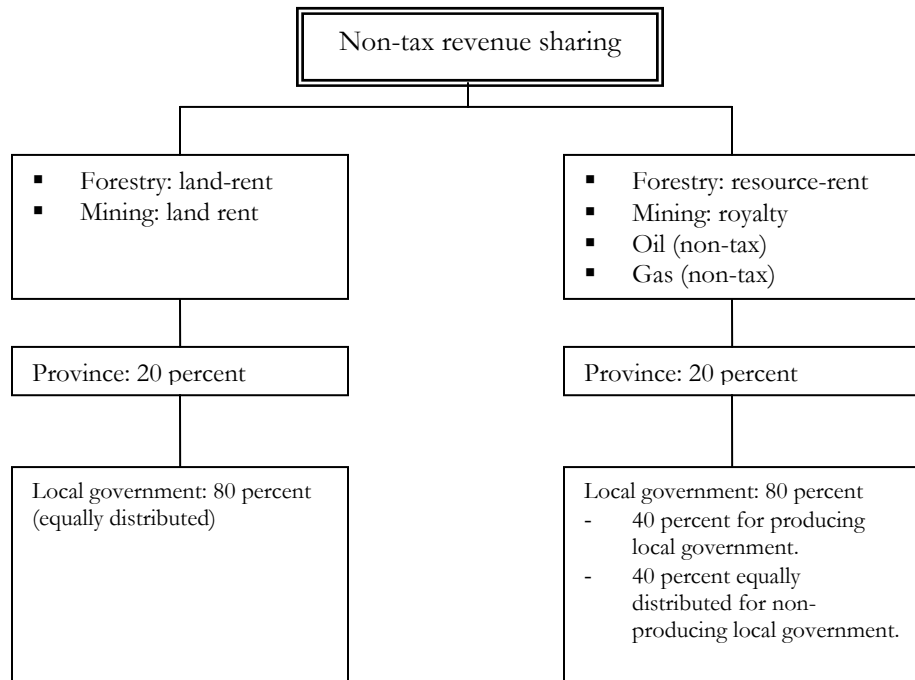
Source: Law 18/2001, Law 33/2004, Law 11/2006 and Qanun 4/2002 compiled by World Bank staff

Notes: ** Distribution among the provincial and local governments is stipulated by Qanun

The allocation of the natural resources sharing between province and local government also follows the 20/80 formula. For revenue generated from the forestry-resource rent, mining, oil, and gas, another 50-50 allocation from the 80 percent allocation for local government is provided for producing and non-producing districts (local government), in which the non-producing local governments have to equally distribute the 50 percent share among them. As for the revenues that do not follow the 50-50 allocation from the 80 percent allocation, the resources have to be equally distributed among local government (Figure2.2).

be 84.5 percent and 69.5 percent, and for regions 15.5 percent and 30.5 percent (in which the 0.5 percent will be allocated for education sector), respectively.

Figure 2.2: Non-tax revenue sharing arrangement for province and local government



Source: Law 11/2006

How the allocation formula works according to the Law 33/2004: Using oil revenue sharing as an example, regions share 15 percent of oil revenue. 30 percent of this is allocated for education or 4.5 percent of oil revenue is for education. The remaining 10.5 percent can be freely allocated by provincial and local governments. The province receives 20 percent, 40 percent to the producing local government, and 40 percent to non-producing local government.

Special Autonomy Fund (Otsus Fund) for Aceh

Law 11/2006 gives Aceh 2 percent from the national general allocation fund (DAU) for 15 years beginning in 2008. The fund will be reduced to 1 percent of the national DAU from 2023 until 2028. According to the law, these funds are intended to finance the development and maintenance of infrastructure, empower the people, alleviate poverty, and to finance the education, health and social sectors. The special autonomy fund will be managed by the provincial government of Aceh.

Other tax revenue sharing

Local governments are also entitled to receive a share of provincial tax revenue. Local government receives 30 percent from the province’s motor vehicle and water vehicle tax and the transfer of motor and water vehicle ownership charges; and 70 percent from motor vehicle fuel tax and water (ground and surface) utilization tax.

General Allocation Fund (DAU)

The DAU (*Dana Alokasi Umum*) is a discretionary block grant designed to equalize the fiscal capacities of regional governments. The DAU is transferred monthly and directly from the center to regional governments. It is allocated based on a national formula that consists of fiscal gap and basic allocation. Fiscal gap is obtained from the difference between the fiscal need and fiscal capacity of each region. Fiscal need takes into account variables such as population, regional area, RGDP per capita, human development index, etc. Fiscal capacity is measured by own-source revenue and regional percent of revenue sharing. As for basic allocation, it is calculated based on the budget spending on civil servants' salary in the related region.

DAU is distributed to the regions with a proportion of 10 percent for province and 90 percent for local government.³² The DAU allocation among local government is obtained by the multiplication of each local government's weight by the total amount of DAU for all local government. The weight itself is determined by the proportion of fiscal gap of the related local government to the total fiscal gap of all local government.

Specific Allocation Fund (DAK)

DAK (*Dana Alokasi Khusus*) is a conditional grant reflecting national priorities provided to finance regions' specific needs not covered by the DAU's formula. DAK cannot be used for research, training, administration, and official travel. The source of DAK comes from the national budget (APBN). However, the region is also required to provide from the regional government budget (APDB) a matching grant of a minimum 10 percent of their budget, except for regions with limited financial capacity.

DAK is transferred quarterly based on project progress. Based on a Ministry of Finance decree, DAK is transferred directly to province and local government. As for Aceh, *Qanun* 4/2002 stipulates that DAK is transferred by the central government to province, which then is responsible for distributing it further to local government. Starting in 2003, DAK covers several sectors such as education, health, infrastructure and government facilities (for new local government).

Other transfers

Besides the three types of transfer mentioned above, regions also receive the deconcentration fund (Decon) from central government.³³ The fund is transferred to the province based on central government priorities for non-physical projects. Law 33/2004 specifies that in the case of emergency, provinces can request emergency fund from the central government to finance extraordinary and urgent needs which cannot be covered by regional government budget (APBD), such as natural disasters.

Own-source Revenue (PAD)

The revised decentralization law has given local governments the opportunity to expand their revenue base, particularly from taxes. Law 33/2004 allows for local taxes, local levies, revenues from local state-owned enterprises and other eligible local revenues. In Aceh, Law 18/2001 adds another

³² Based on Government Regulation (PP 55/2005)

³³ Detail arrangement on deconcentration fund is stipulated in Law 33/2004.

component, *zakat* or alms³⁴, as one of the revenue sources. By and large, arrangements on local taxes are based on Law 34/2000 and government regulations (PP 65/2001 and 66/2001) on regional tax and levies.

Budget Process

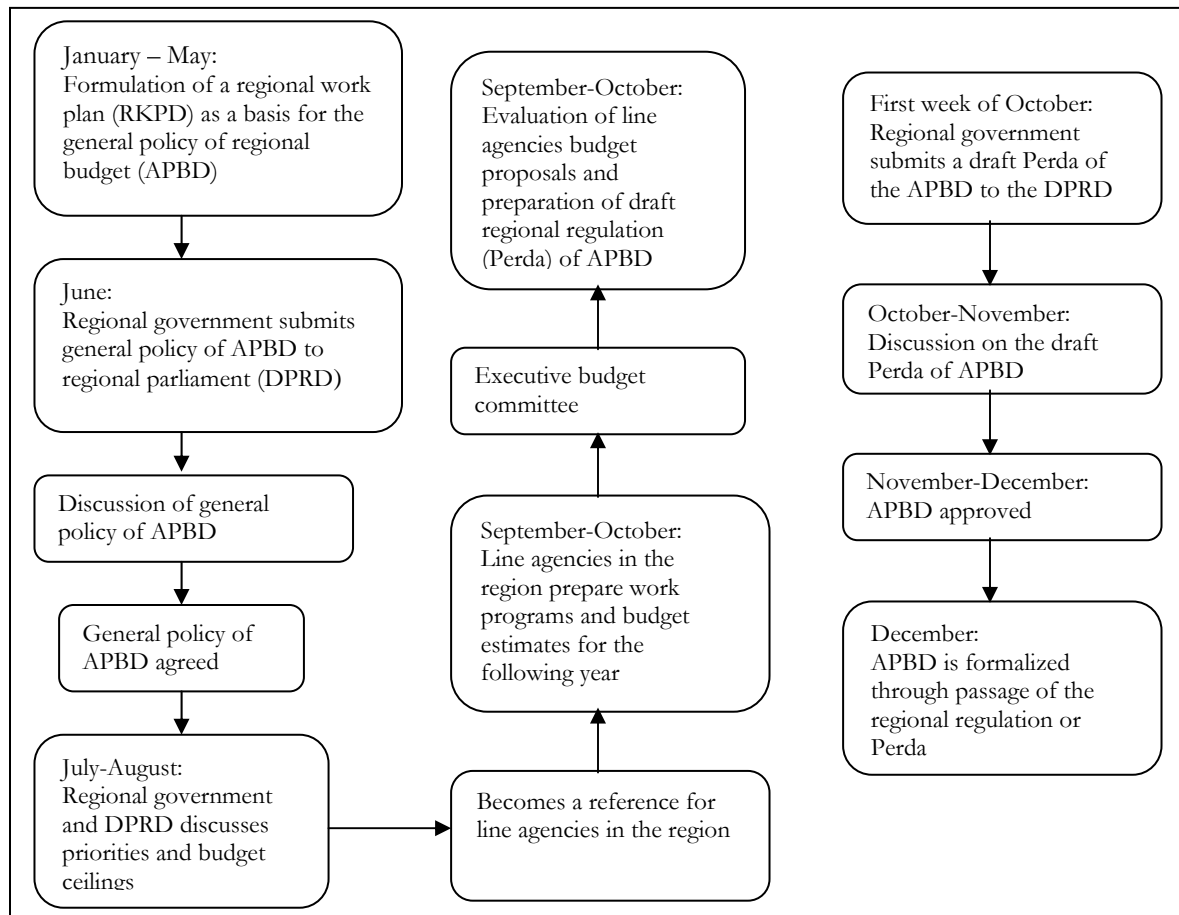
Several pieces of legislation govern budget processes and accountability. Those include Law 17/2003, Law 15/2004, Law 32/2004, Law 33/2004 and Ministerial Decree 29/2002. *Qanun* 4/2002, however, does not include arrangements on budget preparation and process, focusing mainly budget allocations between provincial and local governments. The budget process starts in January of the preceding year when the regional government begins formulating a regional work plan (RKPD) as the basis for the general policy of the regional budget (APBD). In mid-June, the regional government presents the APBD's general policy to Regional Parliament (DPRD). In the first week of October, the regional government submits a draft of the APBD to the DPRD in the form of a local government regulation or Perda.³⁵ At least one month before the fiscal year begins, the DPRD, together with regional government, must agree on the proposed APBD (For more detailed information on the budget process see Figure 2.3).

Budget evaluation begins with presentation of the first semester realizations and estimates of the second semester to the DPRD at the end of July of the fiscal year concerned. As the fiscal year ends, the realization of APBD is audited by BPK (National Auditing Agency) and the audit report should be submitted to DPRD within two months after the APBD is received. Finally, the head of the region submits a draft Perda and an accountability report to the DPRD for approval at the latest six month after end of fiscal year concerned (Figure 2.4).

³⁴ *Zakat* is the amount of money that every adult, mentally stable, free, and financially able Muslim, male and female, has to pay to support specific categories of people (poor and needy). The amount of money that needs to be paid is 2.5 percent of the person's income, which can be done monthly or annually.

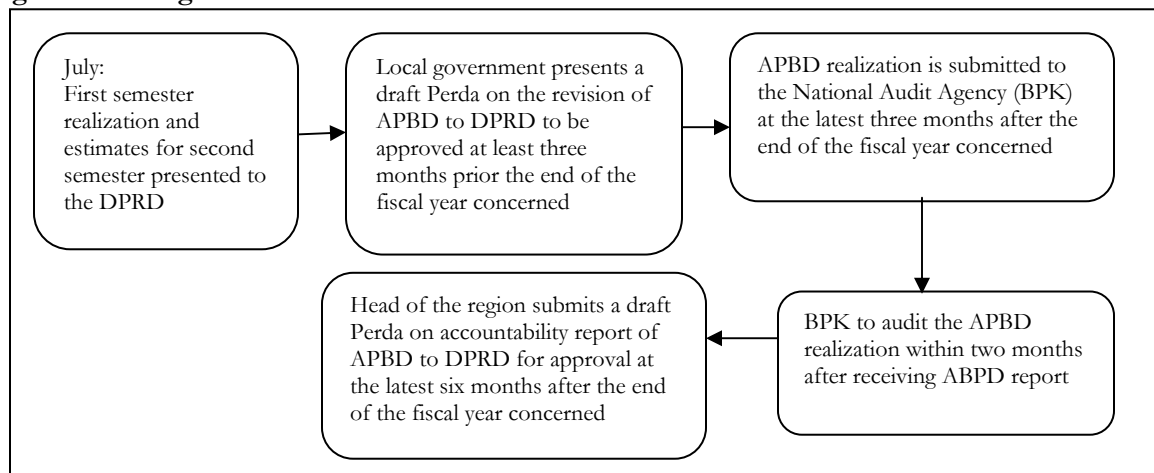
³⁵ Perda is a regional regulation which is formalized by the Head of Region and ratified by the Parliament.

Figure 2.3: The process of budget preparation



Source: DG Budget and Fiscal Balance-MoF based on Law 17/2003, Law 15/2004, Law 32/2004, Law 33/2004, Kepmen 29/2002.

Figure 2.4: Budget evaluation



Source: Law 15/2004, Law 17.2003, PP 58/2005, PP 56/2005.

In practice, the budget process often does not follow the timeline set by the laws and regulations.

A 2005 study on district governments' capacity in 10 tsunami-affected districts shows that it takes an average of four months to receive budget approval by local parliament. According to the laws and regulations, the budget should be submitted to the parliament in October and approved by the parliament before the new fiscal year begins. In a few districts, the budget was submitted after the new fiscal year had begun and was approved as late as June, with Simeulue and Banda Aceh reporting in August 2005. Delays in budget submission and approval were commonplace in Aceh prior to the tsunami, indicating a need for increased coordination between the executive and legislative branches powering following the budget process timeline.

Bottom-up budget planning and timely budget processes are needed for the targets and objectives of regional development to be achieved. Some key issues on budget preparation and implementation that need to be addressed include:

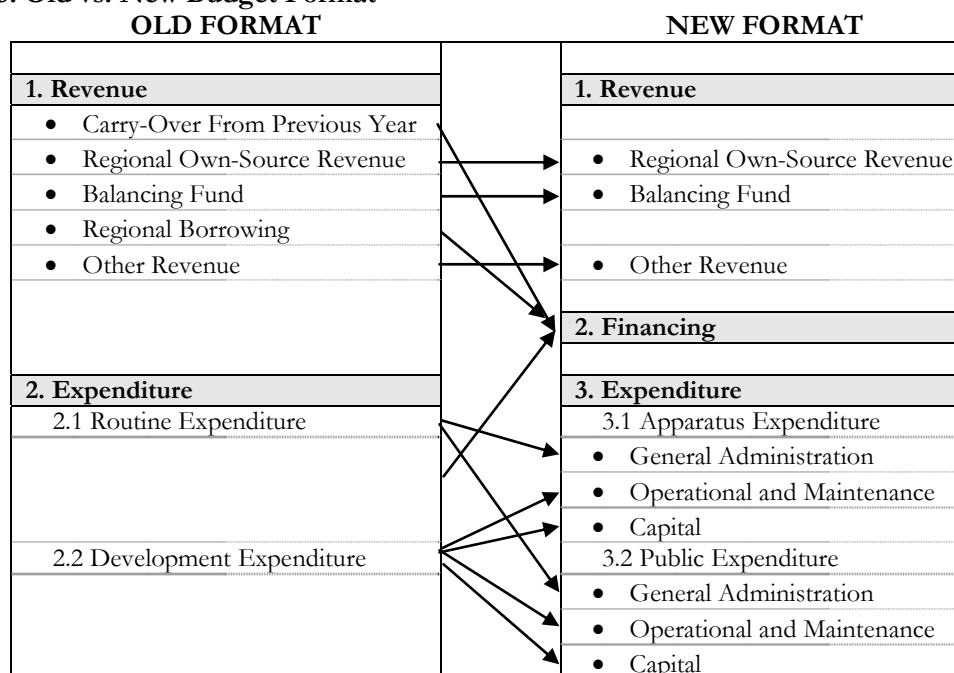
- Inequity between allocated funds and development outcomes across regions.
- Lack of correlation between short-term and long-term development plans in the regional blueprint (*Poldas*), regional development program (*Propeda*), strategic plan (*Restrada*) and general policy purpose.
- Sectoral and geographical gaps: The allocation of public funds, both inter-sector and inter-regional, should meet the needs of a community.

The New Budget Format

Ministerial Decree No. 29/2002 (Kepmen 29) changed the local government budget format. The new budget format has particularly changed the structure of expenditure, while revenue's structure remained largely the same. The new format of revenue excludes carry over and borrowing accounts, and follows the unified budget structure that classified expenditure into government apparatus and public expenditure. In addition, the new budget format has a separate financing account, which includes all borrowing transactions, reserves, and other financing flows (Figure 2.5).³⁶ Among the revenue items now considered financing inflows are loans and carry-over from the previous year. Among expenditures or financing outflows are the carry-over into a following year and payment of loan principal. In addition, the new budget format has also included items such as transfers from/into reserve funds and sale/acquisition of financial assets into financing accounts.

³⁶ The new budget format has been adopted by province and local government in Aceh since 2003. Nationally, the new budget format has been adopted by 197 local government out of 334 local government that have submitted their budget to the Ministry of Finance in 2003.

Figure 2.5: Old vs. New Budget Format



Source: Papua PEACH Report.

The new format of expenditure affects the structure of local budgets significantly as it increases focus on beneficiaries rather than programs/projects. Under the new structure, spending on activities/programs that benefit the general public will be reported under public expenditure, while spending on programs earmarked for the government apparatus will be reported under apparatus expenditure. It is expected that with the new adopted format, duplication on the activities' or projects' budgets can be avoided and better analysis can be carried out. Nevertheless, without clear guidance given to local governments on how to classify items under the new budget format, an analysis of public finances and expenditures may become problematic and optimal results may not be reached.

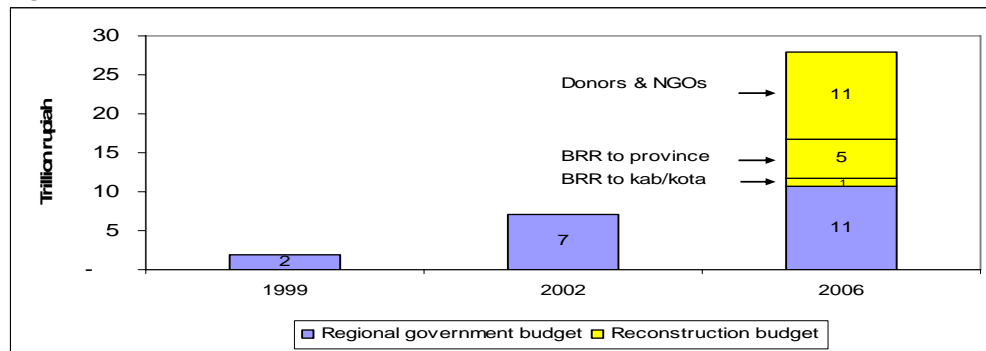
3. REVENUE AND FINANCING

Revenue

The overall picture of revenue in Aceh

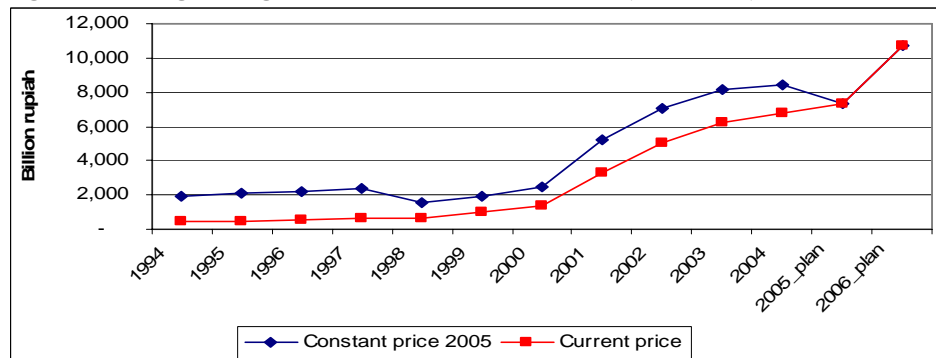
Aceh has been among the main beneficiaries of decentralization and regional funds; total regional revenues increased by more than six times from 1999 to 2006. As with other parts in Indonesia, the Acehese regional government revenue³⁷ increased significantly after the 1999 decentralization legislation. Additional increases to regional revenue came when Aceh was granted Special Autonomy status in 2001. Following the December 2004 tsunami, Aceh received a large amount of reconstruction and rehabilitation funds from communities and donors both inside and outside the country. In 2006, it is estimated that the allocation of funds for reconstruction and rehabilitation will reach about US\$ 1.8 billion (Rp. 17 trillion). The addition of reconstruction funds to the regional government budget will mean that the 2006 regional government fiscal resources will be six times higher overall compared to seven years ago. Starting in 2008, additional resources will be transferred to the region after implementation of the new Law on Governance in Aceh. The revenue of Aceh pre- and post-decentralization, and after the tsunami; and the trend of regional government revenue in Aceh are illustrated in Figure 3.1 and Figure 3.2.

Figure 3.1: Aceh revenue pre- and post-decentralization, and after tsunami



Source: World Bank staff estimates based on data from SIKD/MOF, BPS-SK, and BRR. Data are in real terms (Constant 2005 prices)

Figure 3.2: Regional government revenue in Aceh (1994-2006)

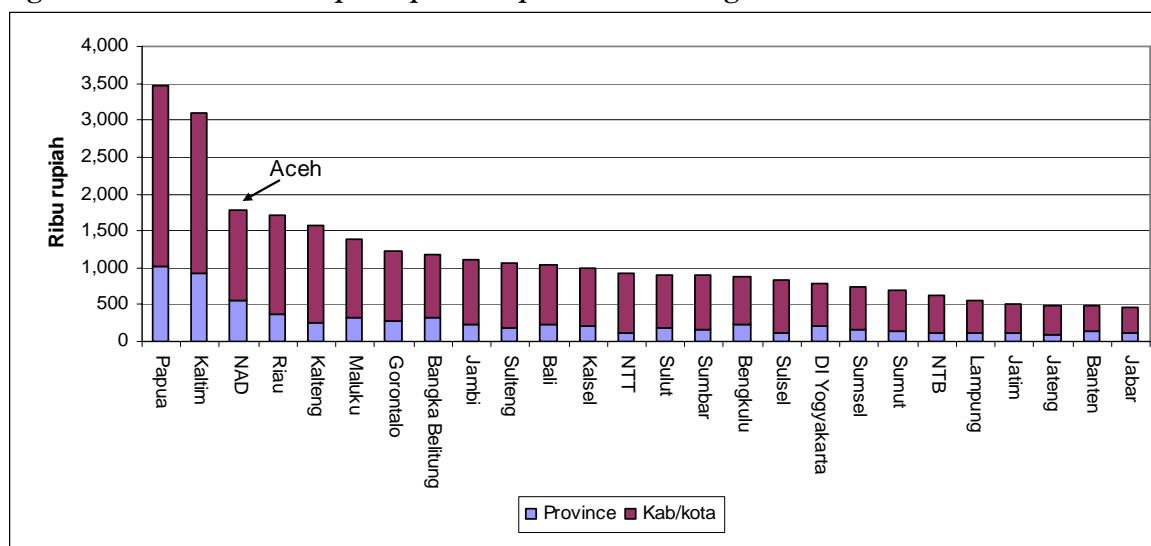


Source: World Bank staff estimates based on data from SIKD/MOF and BPS-SK.

³⁷ The regional government includes provincial and local governments.

In terms of the regional budget (APBD) alone, Aceh is among the richest provinces in Indonesia, and even more so in per capita terms. Although Aceh has only 4.1 million inhabitants, it received Rp. 8.4 trillion in revenues (2004). East Java, with more than 15 million inhabitants, received Rp. 18 trillion. In per capita terms Aceh was among the top three regions in Indonesia, placed only after Papua and East Kalimantan (Figure 3.3).

Figure 3.3: Aceh's revenue per capita compared to other regions in 2004



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

The increase in Aceh's local revenue comes largely from transfers, which increased more than three times in real terms from 1999 to 2004, from Rp. 1.8 trillion in 1999 to 7.1 trillion in 2004 (Table 4.1.1). The role of intergovernmental transfers has been significant in the regional government budget both before and after decentralization. From 1997 to 2000, transfers made up on average 91 percent of total revenue in Aceh, a figure that remained high after decentralization – an average of 87 percent.

Aceh Province receives a relatively larger amount of non-tax revenue sharing compared to the local governments, particularly since 2002 (Table 3.1). Implementation of Special Autonomy in 2002 meant non-tax revenue sharing funds specified in the legislation are transferred into the provincial account. However, the overall revenue composition shows that local governments have more resources both before and after the decentralization was implemented.

Table 3.1: The composition of provincial and local government revenue in Aceh (Rp. Billion)

	1999			2000			2001			2002			2003			2004			2005_plan			2006_projection		
	Province	Kab/kota	Total	Province	Kab/kota	Total	Province	Kab/kota	Total	Province	Kab/kota	Total	Province	Kab/kota	Total	Province	Kab/kota	Total	Province	Kab/kota	Total	Province	Kab/kota	Total
Own Source Revenue	63	86	149	57	82	140	77	79	156	129	117	246	136	146	281	246	158	404	132	136	267	148	133	281
Tax Revenue Sharing	40	164	204	33	138	171	62	264	326	58	210	268	65	256	322	62	391	452	45	277	322	63	275	338
Non-tax Revenue Sharing	14	6	21	13	9	21	261	910	1,172	1,676	1,076	2,752	843	1,269	2,111	2,265	985	3,250	2,265	704	2,969	1,944	2,089	4,032
SDO	79	628	707	72	676	748																		
INPRES	285	590	875	296	1,053	1,349																		
DAU							257	3,016	3,273	209	2,889	3,099	100	2,616	2,716	94	3,043	3,138	271	2,814	3,085	461	4,560	5,021
DAK							11	52	63	0.27	98	99	5	225	229	-	211	211	1	216	217	-	593	593
Others	0	0	0	0	2	2	107	125	232	36	527	562	1,354	1,149	2,503	134	821	955	9	455	464	147	341	488
Total	481	1,475	1,956	471	1,960	2,431	775	4,447	5,222	2,109	4,918	7,027	2,502	5,660	8,163	2,801	5,610	8,411	2,722	4,601	7,323	2,762	7,990	10,752

Source: World Bank staff calculations based on data from SIKD/MOF and BPS-SK. Data are in real terms (constant 2005 prices)

Note:

* SDO (Subsidy for Autonomous Region) was used to pay salaries and other routine operational expenses.

INPRES (Presidential Instruction) was used for development transfers.

** The provincial data of 2005 is using the 2004 figure, since the 2005 provincial data (planned) is still unreliable.

Aceh's most important sources of revenue are the DAU and revenue sharing. Since 2002, these sources of funding have accounted on average for 44 percent and 41 percent of the total revenue, respectively (Table 3.2). The increased revenue from other sources after decentralization is possibly due to the new tax sharing arrangement between the central, provincial, and local governments. Own-source revenue is the smallest source of funds and accounts for only 4 percent of the total revenue. The small share of own-source revenue to total revenue indicates that local government still needs to improve effectiveness and efficiency of the collecting system. Nevertheless, although still the smallest contributor, own-source revenue has also experienced a quite significant increase in volume from 1999 to 2004.

Table 3.2: Share of various revenue sources of total regional revenue in Aceh

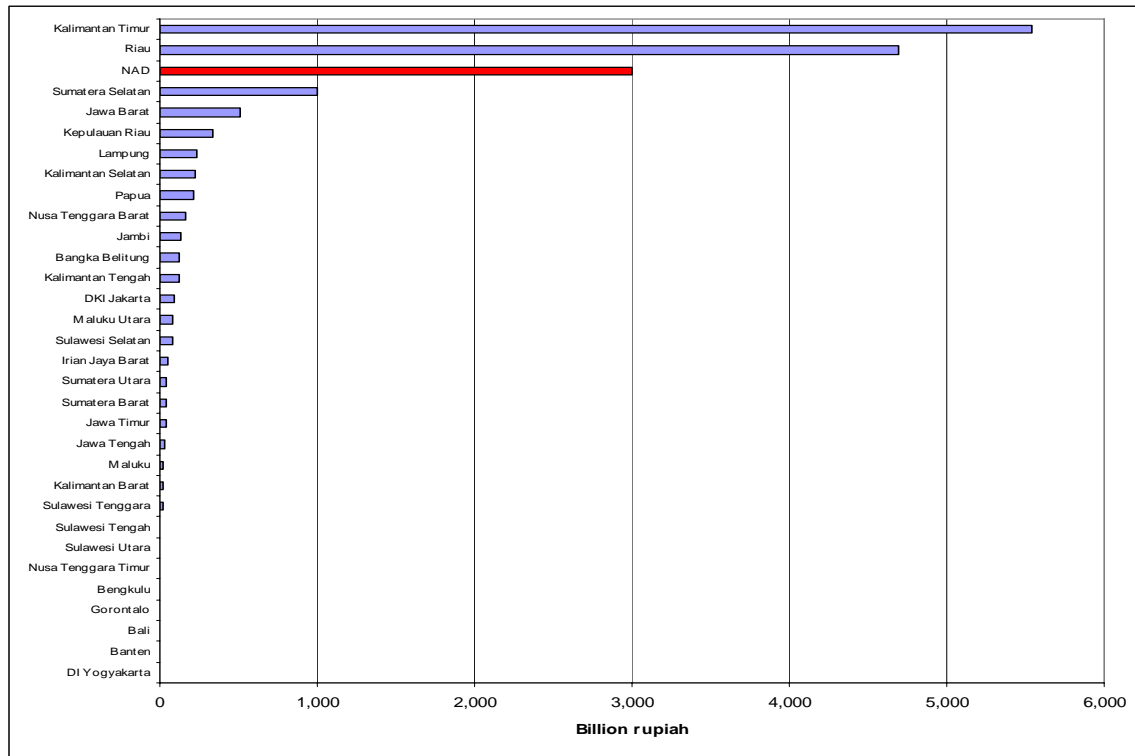
	1997	1998	1999	2000	% avrg pre-dec	2001	2002	2003	2004	2005	% avrg post- dec
Own source revenue	10	10	8	6	8	3	4	3	5	4	4
Revenue sharing	18	17	11	8	14	29	43	45	44	45	41
SDO	39	39	36	31	36						
INPRES	33	33	45	55	42						
DAU						63	44	33	37	42	44
DAK						1	1	3	3	3	2
Others	0.15	0.02	0.02	0.10	0.07	4	8	16	11	6	9
Total transfer	90	90	92	94	91	93	88	81	84	90	87
Total revenue	100	100	100	100	100	100	100	100	100	100	100

Source: World Bank staff estimates based on data from SIKD/MOF and BPS-SK.

*Note: * In 2003, the amount of 'other revenue' is very high. It is likely that some of the amount belongs to the revenue sharing. Thus, it is assumed that 15 percent of the shares from others revenue is allocated to revenue sharing.*

The large share of revenue from natural resources revenue sharing gives Aceh the opportunity to boost development if resources are used wisely. Revenues from revenue sharing are much higher than national average (41 percent vs. 20 percent). As in Aceh, out of the total Rp. 3.7 trillion of revenue sharing in 2004, about Rp. 3.2 trillion is contributed from the natural resources shares and only Rp. 452 billion comes from the tax sharing. After the implementation of special autonomy, the volume of natural resources revenue sharing in Aceh increased from Rp. 21 billion in 1999 to Rp. 2.8 trillion in 2002, and further to Rp. 3.2 trillion in 2004, thus increasing overall by more than hundred times.

Figure 3.4: The allocation of fund from natural resources sharing across province in Indonesia, 2004



Source: Ministry of Finance; World Bank staff estimates

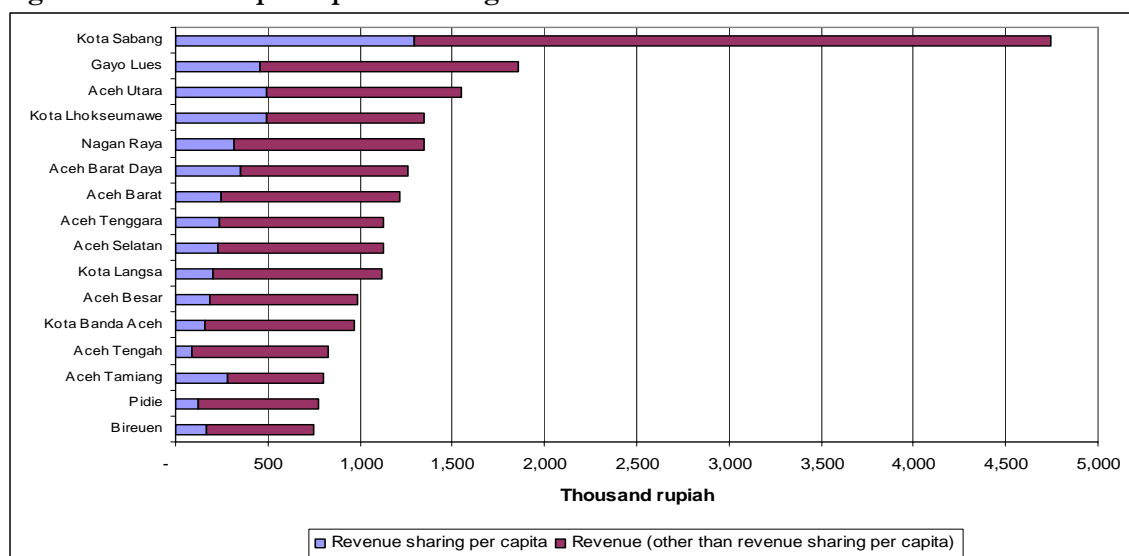
Moreover, the volume of funds from revenue sharing will also decline should the level of oil/gas production decline.

Fiscal disparity and inequality

Although Aceh is among the regions with the highest revenue per capita, the disparity in the distribution of revenue per capita among local governments is significant. In 2004, one of the richest districts (Kota Sabang) had more than twice the revenue (per capita) of the poorest district (Kab. Bireun) (Figure 3.5).³⁸

³⁸ This assessment is based on data of 16 out of 21 local government (data is unavailable for the remaining local government).

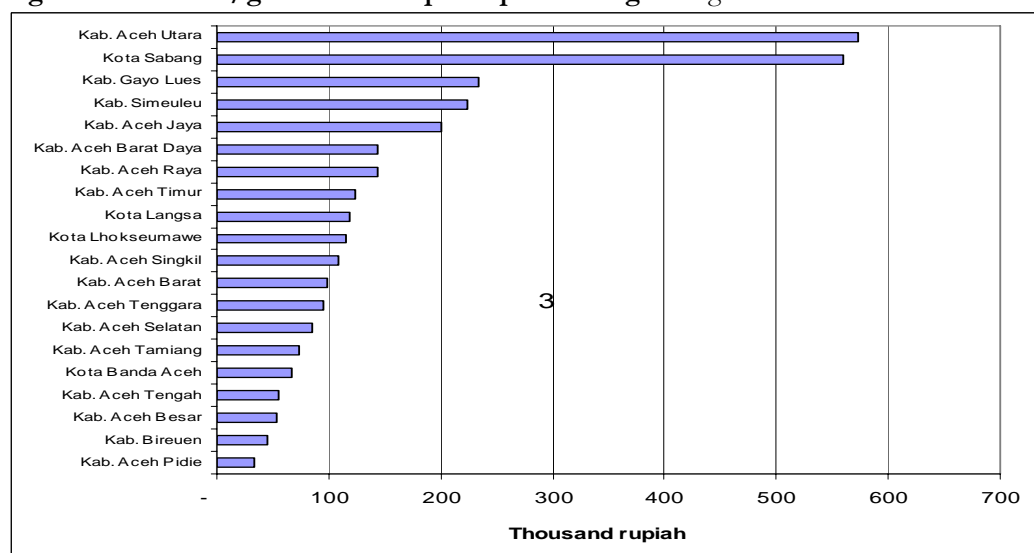
Figure 3.5: Revenue per capita of local government in Aceh 2004



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

As with other parts of Indonesia, there are significant inequalities in the allocation of revenues from oil and gas. The allocation of oil and gas revenue in 2004 shows that Kab. Aceh Utara as a producing district received over 15 times the allocation of oil and gas revenue to Aceh Pidie (a non-producing district) (Figure 3.6).

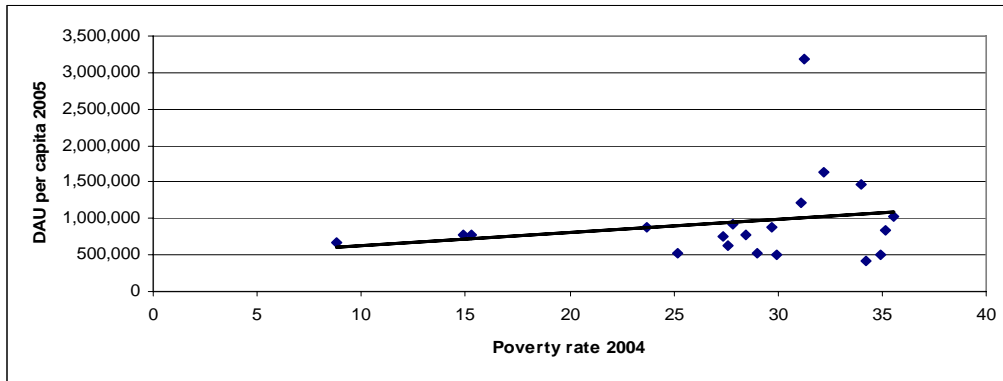
Figure 3.6: The oil/gas allocation per capita among local government in Aceh in 2004



Source: Ministry of Finance; World Bank staff estimates.

The allocation of DAU among local governments should reduce inequality arising from the revenue sharing. In reality, the DAU as a block grant does not address the imbalances in revenues across *kabupatens*. To correct imbalances, regions with higher poverty rates should receive higher transfers. There is effectively no correlation between the poverty rate and the amount of DAU received by *kabupatens*; regions with higher poverty rates did not receive considerably higher transfers than regions with lower poverty rates (Figure 3.7).

Figure 3.7: DAU per capita and poverty rate in Aceh



Source: World Bank staff estimates based on data from MOF and BPS.

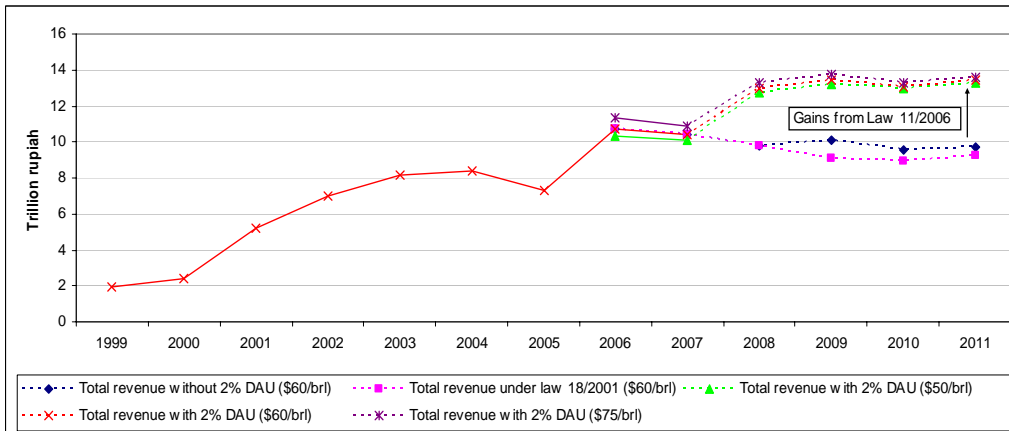
Revenue Projection

In 2008, Aceh will begin receiving additional revenue according legislated in Law on Governance in Aceh, approved in August 2006. In addition to Aceh’s current revenue sources, the region would receive a new source of revenue from DAU allocation: 2 percent of national DAU allocation for 15 years followed by 1 percent of national DAU allocation for the following 5 years (until 2028). The additional funds are intended to finance the development and the maintenance of infrastructure in Aceh, as well as financing economic empowerment, education, social and health sectors.

The new Law also revises oil and gas revenue sharing between central and regional government. There will be no reduction from the share of oil and gas revenue that Aceh receives in 2009 and Aceh will continue to receive 70 percent from oil and gas revenue. Instead, the anticipated reduction in funds from natural resources revenue sharing will come from the decline in oil and gas production.

Taking the additional funds into account, Aceh’s revenues are likely to increase starting in 2008. Revenue is set to increase to more than Rp. 13 trillion in 2009 and then decline slightly due to the depletion of oil and gas reserves. The 2 percent additional fund from DAU allocation will somewhat compensate for the declining revenue from oil and gas production (Figure 3.8).

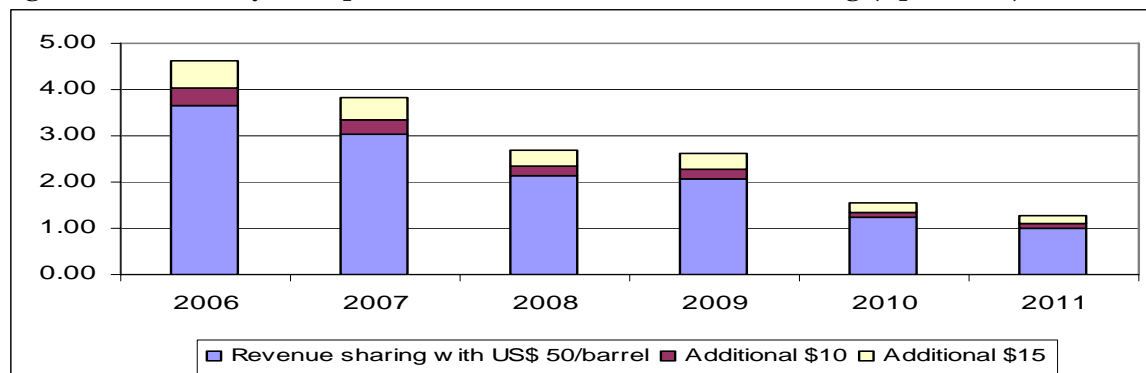
Figure 3.8: Aceh’s revenue projection with and without 2% DAU allocation



Source World Bank staff calculation based on data from SIKD/MOF and PT, Arun LNG.

Since oil and gas are Aceh's principle natural resources, the shared revenues will decrease to less than Rp. 4 trillion in 2007 and will rapidly fall to Rp. 1.5 trillion or less after 2009 (Figure 3.9). This sharp drop will be mitigated by a continuing increase in DAU as well as other revenues by 2011.

Figure 3.9: Sensitivity of oil price to natural resources revenue sharing (Rp. trillion)



Source World Bank staff calculation based on data from SIKD/MOF and PT, Arun LNG.

Own-source Revenue (PAD)

Similar to other regions in Indonesia, fiscal decentralization has not improved local government PAD in Aceh. Despite fiscal decentralization, major taxes remain the purview of the central government. For example, land and property taxes (PBB) that have been largely decentralized in other countries are still collected by the central government in Indonesia and then transferred to the provinces. Prior to decentralization, PAD contributed less than 3 percent of total local government revenue and 7 percent of total province's revenue.

The provincial PAD has increased after decentralization but experienced a sharp decrease in 2005. The shrinking of PAD in 2005 was the consequence of the tsunami, which affected many potential tax bases and hampered the tax collection. The increase in PAD after decentralization was driven mainly by the expansion of the tax base for the motor vehicle tax and the addition of the surface and ground water utilization tax. Among provincial PAD, provincial taxes have steadily been the major contributor with more than two thirds in total PAD. Other eligible PAD—the second largest contributor—has increased substantially after decentralization (Table 3.3).³⁹

The motor vehicle ownership transfer tax is the main contributor to provincial taxes, while the street lighting tax is the most important of local government local taxes in Aceh. In 2004, the motor vehicle ownership transfer tax contributed 46 percent to total provincial taxes. It was followed by motor vehicle tax (31 percent) and motor vehicle fuel tax (20 percent). The street lighting tax played a major role in local government taxes, with more than 70 percent contribution, followed by hotel and restaurant tax and the extracting and processing of mining resources type C tax.

³⁹ Third party donations may include contributions in form of grant from donors, NGOs, or private that is donated directly to local government (and contributions from the contractors in amount of 5 percent of the project). *Gim* service may include tax on bank transaction and bank interest from local government deposit

Table 3.3: Composition of provincial PAD in Aceh

Own Source Revenue	1999		2001		2002		2003		2004		2005	
	Rpmio	%	Rpmio	%	Rpmio	%	Rpmio	%	Rpmio	%	Rpmio	%
Provincial Taxes	56,625	90	68,222	89	101,129	78	113,969	84	171,495	70	106,995	81
Rebutions	3,239	5	4,588	6	4,529	4	4,313	3	4,782	2	2,620	2
Profit from Regional Owned Enterprises	138	0	787	1	1,926	1	2,053	2	2,273	1	2,105	2
Other Own Source Revenues	2,873	5	3,129	4	21,439	17	15,448	11	67,586	27	19,780	15
Total	62,876	100	76,726	100	129,022	100	135,783	100	246,135	100	131,500	100

Source: World Bank Staff calculations based on data from SIKD/MoF and World Bank Decentralization database. Data are in real terms (constant 2005 price).

Local government PAD increased after decentralization, but declined in 2004 and 2005 as the result of conflict and the tsunami. The composition of local government PAD has also changed after decentralization. Before decentralization, local taxes played a major role in local government PAD, representing more than 70 percent of total PAD. The role of local taxes in the total tax collection decreased after decentralization as the category “other eligible PAD” (*giro* services and third party contributions) gained importance (Table 3.4).

Table 3.4: Composition of local government PAD in Aceh

Own Source Revenue	1999		2001		2002		2003		2004		2005	
	Rpmio	%	Rpmio	%	Rpmio	%	Rpmio	%	Rpmio	%	Rpmio	%
Local Taxes	61,999	72	33,894	43	34,128	29	28,895	21	33,293	23	33,852	26
Rebutions	24,070	28	19,887	25	34,549	29	25,156	18	30,010	21	30,270	24
Profit from Regional Owned Enterprises	171	0.20	479	1	3,084	3	2,222	2	3,738	3	4,919	4
Other Own Source Revenues	0	0	25,153	32	45,593	39	83,890	60	76,319	53	59,622	46
Total	86,240	100	79,413	100	117,354	100	140,163	100	143,360	100	128,663	100

Source: World Bank Staff calculations based on data from SIKD/MoF and World Bank Decentralization database. Data are in real terms (constant 2005 price).

The small contribution of regional taxes and charges to PAD is potentially due to low tariff rate. Some *kabupatens* and *kota* have started to adjust tariff rates by revising obsolete regional regulations. This tariff adjustment has been applied in several local government, such as Kab. Aceh Tamiang, Kab. Aceh Timur, Kota Langsa, Kab. Bener Meriah, and Kab. Aceh Tengah. The initial implementation of tariff rates met with only limited success as many tariff rates remained too high. Tax collection has improved with a more stable security situation and investment climate has improved since the signing of the Helsinki MoU.

Although Law 18/2001 has officially specified *zakat* as source of PAD for the provincial and local governments in Aceh, in practice *zakat* has not been recorded in their budgets. There are several reasons for this:

- i) Many local government have not established a *zakat* managing institution (*Baitul Maal*)⁴⁰
- ii) Communities are not sure whether the *zakat* they pay was properly delivered to the 8 *asnaf* (*zakat* receivers according to Islamic rule), and
- iii) *Zakat* managing institutions lack human resources, information, and technology.⁴¹

Thus far, the management and administration of *zakat* has been conducted by individual Islamic organizations, regional government offices, local state-owned companies, and private companies. The

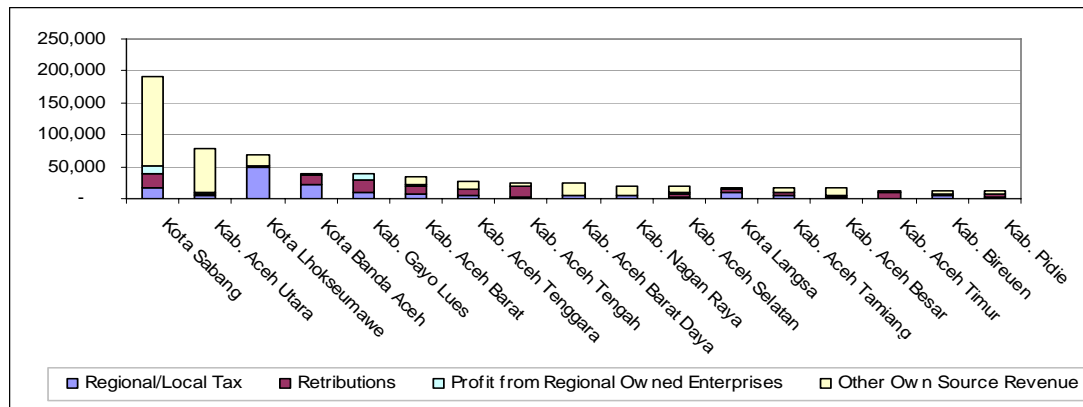
⁴⁰ In Kab. Aceh Timur which established Baitul Maal the collection of *zakat* reached Rp. 1 billion annually.

⁴¹ Interview with Head of Baitul Maal in Kab. Aceh Timur.

local governments have mainly collected *zakat* as a 2.5 percent of monthly salary of government employees.

There is high degree of disparity in PAD per capita among local government in Aceh. Kota Sabang has more than 15 times higher PAD per capita than Kab. Pidie. The top 5 highest PAD per capita local governments were dominated by urban areas (*kota*). This might imply that the current structure of local taxes and charges benefits urban areas (Figure 3.10).

Figure 3.10: Per capita PAD across local government in Aceh, 2004



Source: World Bank Staff calculation based on data from SIKD/MoF, BPS and World Bank Decentralization database.

The conflict between GAM and the Government of Indonesia had been the major impediment to the PAD growth⁴² in the region. The conflict severely limited all economic activity, thus negatively impacting overall PAD. The conflict also prevented government officials from collecting taxes.⁴³

The creation of new *kabupaten* has also created some problems for the distribution of PAD sources between the original and the newly established local government. First, there is unclear division on asset management and tax administration between the original and new local government. The original local government still performs tax collection, while administratively those assets have been given to and are located in the new local government territory. For example, the newly established *kabupaten* Aceh Tamiang has not received its share of profits retained from PDAM's operation⁴⁴ and the management of swift bird nests (*sarang burung walet*) from its original *kabupaten* (Aceh Barat), despite the fact that their operation and management are located within Kab. Aceh Tamiang's jurisdiction. Second, the newly established local government often lacks capacity in tax administration and collection. Third, creating new *kabupaten* has drained the original local government loose of potential PAD sources.

⁴² Interview with the Head of *Dispenda* (District Revenue Office) in Kab. Aceh Timur.

⁴³ Third party donations may include contributions in form of grant from donors, NGOs, or private that is donated directly to local government (and contributions from the contractors in amount of 5 percent of the project). Giro service may include tax on bank transaction and bank interest from local government deposit

⁴⁴ *Perusahaan Daerah Air Minum* or Local state-owned water company.

Revenue Sharing (Tax and Natural Resources)

Tax-Sharing

The tax-sharing arrangement between the central government and the region has changed after decentralization. Personal income tax was entirely administered and collected by the central government prior to decentralization, now the regional government receives a 20 percent share of this tax. The expansion of personal income tax base⁴⁵ has the potential to boost regional government revenue from personal income tax. Although the land and building tax (PBB) and real estate transfer tax (BPHTB) are still administered by the central government, the revenue from these two taxes are now entirely transferred to regional governments.⁴⁶ Previously, 20 percent of the revenue from both PBB and BPHTB were kept by the central government.

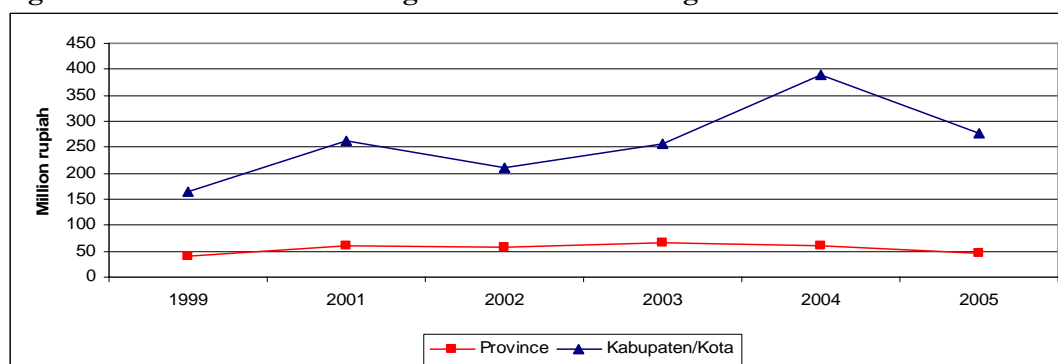
Local governments are now entitled to receive some additional tax-sharing from the province. Under revised tax-sharing agreements, local governments now receive 30 percent of two provincial taxes, vehicle tax and vehicle transfer tax. Prior to decentralization, local government were only entitled to receive a percentage of provincial fuel taxes, an amount now reduced from 90 percent to 70 percent. The administration of ground and surface water utilization tax has been shifted to the province, with a 70 percent sharing arrangement to local government.

Aceh received increasing revenue from tax-sharing after decentralization and revenue is expected to further increase in the coming year. Revenues from tax sharing to province and local government increased by 60 percent between 1999 and 2001. Since 2001, there have been some fluctuations in the revenue from tax-sharing, most likely due to the unstable security conditions. The tsunami also had also a strong impact on the declining revenues from the tax-sharing in 2005 by damaging or destroying thousands of homes and businesses, all which are potential sources for land and building tax and real estate transfer tax. The province's revenue from tax-sharing decreased from Rp. 65 million in 2003 to Rp. 45 million in 2005. After enjoying a steady increase in 2003 and 2004, the revenue of local government's tax-sharing decreased significantly from about Rp. 400 million in 2004 to almost Rp. 250 million in 2005 (Figure 3.11).

⁴⁵ Law 33/2004 and Government Regulation (PP) 22/2005 expand the tax base for income tax -sharing with addition of PPh article 25/29 domestic personal income tax and PPh article 21.

⁴⁶ Law 34/2004 specifies that 90 percent of PBB tax to be shared to the regional government (16.2 percent to the province, 64.8 percent to local government and 9 percent for administration and collection cost), 6.5 percent to be distributed equally to all local government and 3.5 percent to be distributed as incentive to local government that achieve/exceed the revenue plan/target. As for BPHTB, 16 percent is shared to the province and 64 percent is allocated to local government. The rest 20 percent is shared equally to all local government. Out of 20 percent of personal income tax-sharing, the province receives 60 percent while the rest 40 percent transfers to local government

Figure 3.11: Provincial and local government tax-sharing in Aceh



Source: World Bank Staff calculation based on data from MoF/SIKD

Although the regional government had enjoyed higher revenue from tax-sharing after decentralization, in fact its contribution to total revenue has declined over the years. Prior to decentralization tax-sharing contributed more than 8 percent to total provincial revenue; in 2005 it was recorded below 2 percent. Similar to the province, the contribution of tax-sharing to local government revenue experienced a decline from 11 percent in 1999 to 6 percent in 2005. This declining role of tax-sharing can be explained by remarkable increase of central government transfer (DAU) to local government after decentralization (Table 3.4)

Table 3.5: Tax-sharing of province and local government in Aceh (Rp. Million)

Year	Province			Local government		
	Tax Sharing	Total Revenue	% Tax-Sharing to Total Revenue	Tax Sharing	Total Revenue	% Tax-Sharing to Total Revenue
1999	40	481	8.3	164	1,475	11.1
2001	62	775	8.0	264	4,447	5.9
2002	58	2,109	2.8	202	4,802	4.2
2003	65	2,502	2.6	269	6,145	4.4
2004	62	2,801	2.2	366	5,469	6.7
2005	45	2,722	1.7	329	4,505	7.3

Source: World Bank Staff calculation based on data from MoF/SIKD

Personal income tax has historically been the most important source of tax-sharing revenue for the province. Before decentralization, PBB represented almost 90 percent of total provincial tax-sharing. After decentralization, contributions from personal income tax have increased to about 1/3 of total tax-sharing revenue, which also increased the province's revenue and balanced the importance of PPB (Figure 3.13).

Figure 3.12: Composition of province's tax-sharing

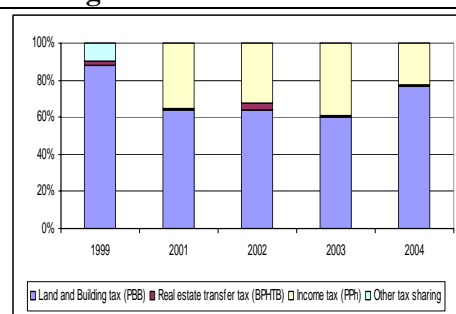
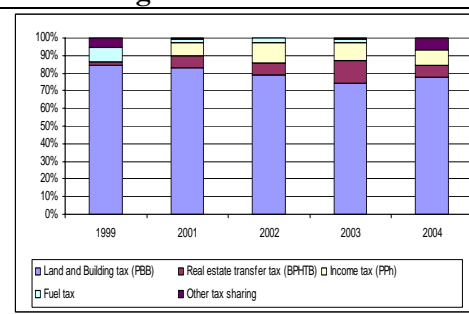


Figure 3.13: Composition of local government's tax-sharing



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

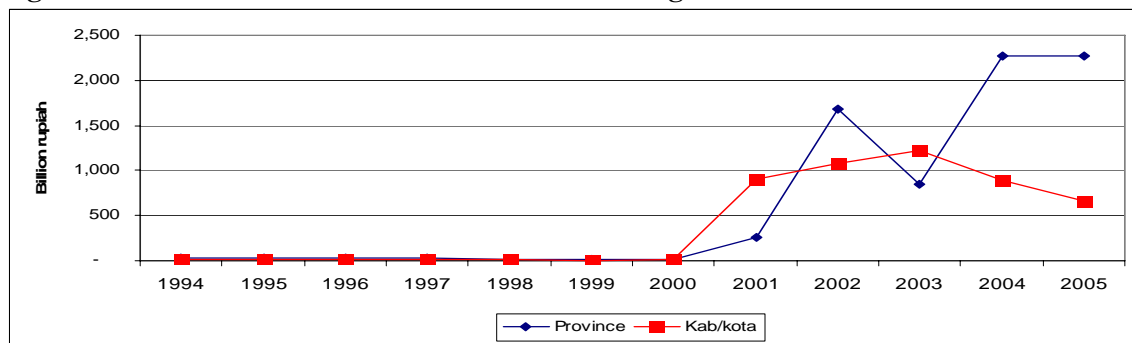
PBB has also been the most important source of tax-sharing revenue for local government in Aceh. In 1999, PBB made up almost 90 percent of total tax-sharing. Its role has been declining after decentralization, but still contributing two-third of total tax-sharing (Figure 3.13).

Natural resources (non-tax) revenue sharing

Law 33/2004 provides for more types of natural resources revenue sharing between the national and regional governments. Previously, natural resources revenue sharing only included forestry and mining. Under Law 33/2004, fisheries, oil, and gas are also included under the revenue sharing arrangement. The special autonomy status of Aceh has granted the region additional revenue of 55 percent from oil and 40 percent from gas.

Prior to fiscal decentralization, natural resources revenue sharing received by provincial and local governments was very limited, both in terms of the amount and types of revenues. On average, revenue sharing from natural resources accounted for only 1.4 percent of total revenue in the period before decentralization. The amount increased significantly after decentralization and reached up to Rp. 3.2 trillion or 40 percent of total revenue in 2004.

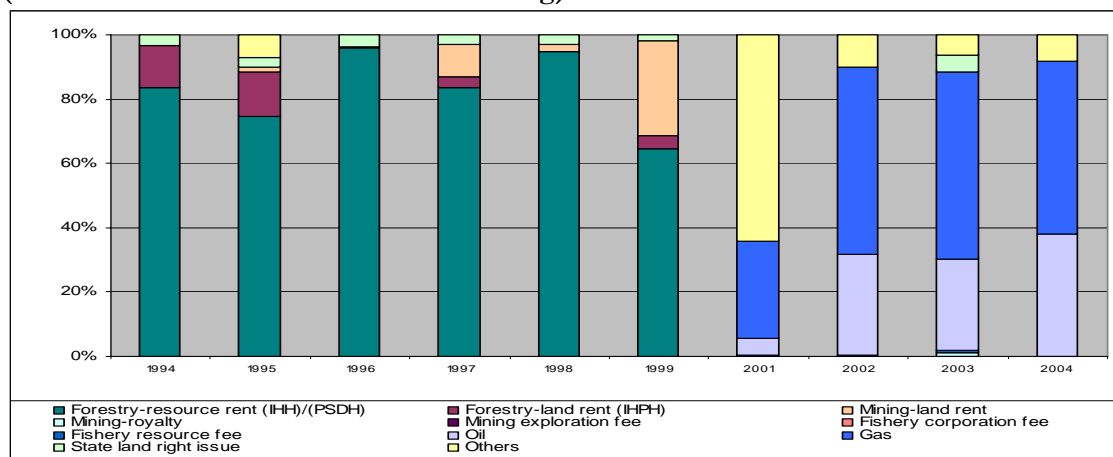
Figure 3.14: Trend of natural resources revenue sharing in Aceh



Source: World Bank staff calculation based on data from SIKD/MOF. Data are in real terms (constant 2005 price)

The expansion in types of revenue sharing has changed the composition of natural resources revenue sharing and beneficiaries within Aceh. Forestry resource rent, which used to be the main contributor of natural resources revenue sharing, has been replaced with oil and gas as the main contributor. The shares of forestry resource rents declined significantly from an average of 64 percent before 2001 to 0.2 percent after decentralization. Instead, oil and gas have become the main source of revenue sharing from natural resources with an average share of 26 percent for oil and 50 percent for gas. The somewhat oddly high share of ‘others’ in 2001 is probably due to misclassification at the beginning of implementation period of decentralization.

Figure 3.15: Composition of natural resources revenue sharing pre- and post-decentralization (% of total natural resources revenue sharing)



Source: World Bank staff calculation based on data from SIKD/MOF

In terms of beneficiary, all local government in Aceh received higher revenue sharing from natural resources after decentralization. The weighted annual average for local government shows an increase from Rp. 0.9 billion to Rp. 53 billion. Aceh Utara as the producing region becomes the major recipient from natural resource revenue sharing after decentralization, while before Aceh Barat was the largest beneficiary

Table 3.6: Benefits from natural resource revenue sharing, by region (m Rp)

	Annual average pre-decentralization	Annual average post-decentralization
1_Aceh Barat	3,110	66,414
2_Aceh Besar	199	44,617
3_Aceh Selatan	1,619	44,484
4_Aceh Singkil	-	242
5_Aceh Tengah	1,331	31,463
6_Aceh Tenggara	396	54,111
7_Aceh Timur	1,632	56,129
8_Aceh Utara	269	418,719
9_Bireuen	-	33,066
10_Pidie	137	66,986
11_Simeulue	-	13,388
12_Kota Banda Aceh	184	47,293
13_Kota Sabang	95	10,569
14_Kota Langsa	-	20,884
15_Kota Lhokseumawe	-	18,988
16_Aceh Barat Daya	-	30,096
17_Gayo Lues	-	31,620
18_Aceh Tamiang	-	38,225
19_Nagan Raya	-	14,200
20_Aceh Jaya	-	18,733

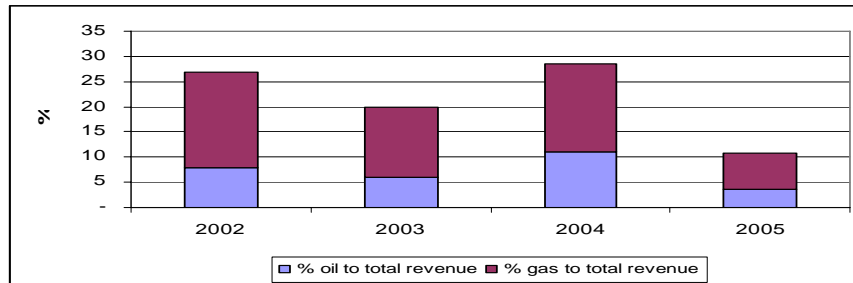
Source: Ministry of Finance and World Bank staff calculation

The Special Autonomy Fund (Dana Otonomi Khusus)

Aceh has greatly benefited from special autonomy status with regard to higher revenue sharing from oil and gas. In total, Aceh receives 70 percent of revenue sharing (net-tax) from oil and gas, which is far above the national sharing arrangement. This specific scheme has been viewed as an attempt to resolve the long-standing conflict in the region. Although the former autonomy law was passed in 2001, Aceh started to enjoy its large revenue from oil and gas in 2002. On average, about 70 percent of these revenues come from gas revenue sharing and the other 30 percent comes from oil revenue sharing. As specified in the new Law of Governance of Aceh, starting 2008 Aceh will receive additional revenue 2 percent of national DAU allocation

Although the special autonomy fund has become one of the main sources of revenue for Aceh, it has been steadily declining since 2002. This declining trend should receive particular attention from the regional government in Aceh. The accumulation of special autonomy funds allocated to Aceh from 2002 to 2005 reached Rp. 5.3 trillion.⁴⁷ In the first year, the allocation reached Rp. 1.9 trillion which significantly boosted the regional government revenue. Since then, the allocation has continuously declined, reaching only Rp. 775 billion in 2005. As a result, its share in total regional government's revenue has also declined from 27 percent in 2002 to 11 percent in 2005 (Figure 3.16).

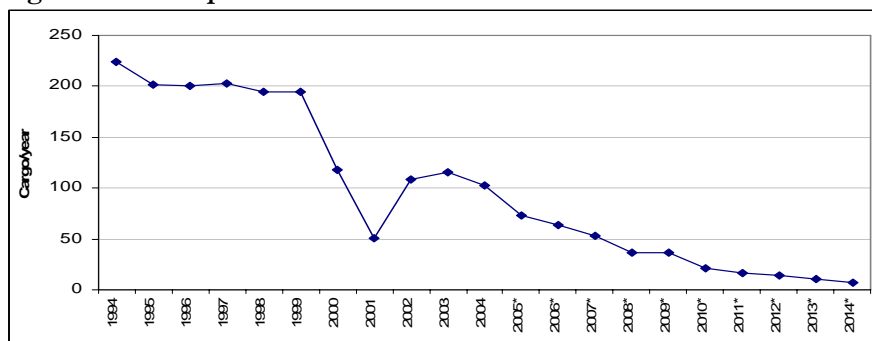
Figure 3.16: Aceh's Special autonomy fund as percentage of total revenue



Source: Various Ministry of Finance Decrees (KMK 241/2002, KMK 237/2003, KMK 275/2004, PMK 42/2005). Data are in real terms (constant 2005 prices)

Although Aceh has benefited from its special autonomy status, declining oil and gas production in the future means that the revenue from this source is likely to continue decreasing.⁴⁸ It is estimated that the volume of production of gas in Kab. Aceh Utara decline to only 7 cargoes/year in 2014 (Figure 3.17). Although Aceh will continue benefiting from other revenue sources, it is essential that the provincial and local governments in Aceh make a strategic allocation of public spending anticipating the decline in revenue from special autonomy funds.

Figure 3.17: Gas production of PT. Arun LNG in Aceh



Source: PT. Arun LNG, 2004. Figures from 2005 onward are estimated. Figures are measured in cargo, 1 cargo=9.82 MCFD (Million Cubic Feet per Day)

⁴⁷ This amount refers only to the Special Autonomy Fund and is in addition to the funds Aceh receives through the 'normal' sharing of natural resources revenue between the central and regional governments.

⁴⁸ The production of natural gas is started in 1978 with a level of production of 250 MCFD (Million Cubic Feet per Day). The highest production level was reached in 1994 amounting to 2,200 MCFD or equivalent to 224 cargoes, while the lowest one was in 2001 for only 51 cargoes. After 27 years, it is estimated that more than 90 percent of natural gas resources has been exploited. In the beginning of 2005, the production was 900 MCFD. The projection done by PT. Arun NGL indicates a declining trend reaching 100 MCFD in 2018.

The 1999 national decentralization system was designed to empower local governments whereas the special autonomy legislation gives the lion's share of fiscal resources to the provincial government. The province therefore should be made more accountable for its resource allocation as well as be more responsive public service needs. The special autonomy fund is boosting revenues in producing regions. Kab. Aceh Utara, as the main producing *kabupaten* of oil and gas, has received significant additional revenue from the special autonomy fund. After the implementation of the special autonomy law, these funds represented 41 percent of Kab. Aceh Utara's total revenue and 61 percent of total transfers. Nevertheless, current declining trends mean that Kab. Aceh Utara has to use its funds in a strategic and efficient manner whilst finding alternative sources to finance their expenditure in the future.

Table 3.7: Share of special autonomy fund to total revenue and total transfers in Aceh Utara

	2003	2004	2005
Oil	98,302	87,533	96,670
Gas	227,799	135,624	268,100
Total	326,102	223,157	364,769
% of total transfer	72	50	62
% of total revenue	35	30	58

Source: Dinas Pendapatan Daerah Kabupaten Aceh Utara, Ministry of Finance, and World Bank staff calculation.

**: Special autonomy fund in 2002 was recorded in 2003 due to the transfer delay from central government to province.*

Five years into special autonomy, some challenges remain relating to the transfer and allocation of special autonomy funds. The central government has not provided reliable data, both on oil and gas production as well as data on costs related to the exploration. Without this data, regional governments cannot make an accurate calculation of revenue sharing. The lack of transparency on other costs such as management fees and taxes also limits accuracy in calculating shared revenue.

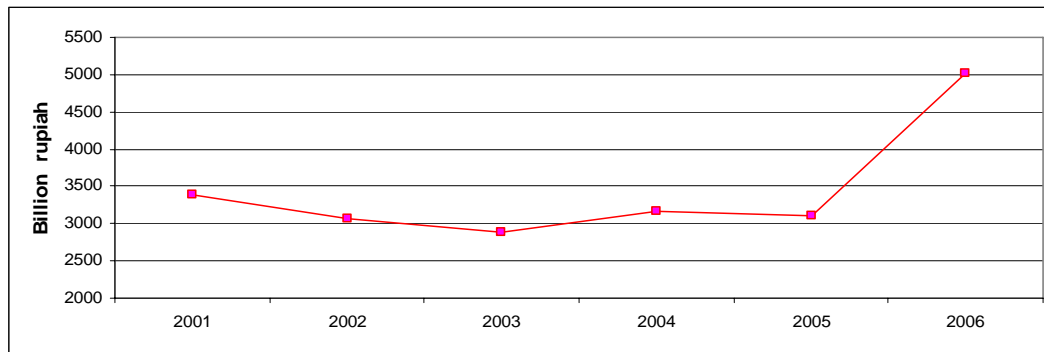
Local governments frequently experienced delays on the transfer of special autonomy funds, which disturb their cash flow and disrupt the implementation of development programs. Shared revenue is to be transferred every quarter, starting with the first quarter in around December to February of the following year, but delays are very common. For example, Kab. Aceh Utara's March 2006 transfer was only received in June 2006.

During military operations, a large portion of the special autonomy funds was diverged to finance military operations and other security related activities. Future transfer and allocation of the special autonomy fund should be improved, especially with regard to the urgent reconstruction needs and the implementation of the Helsinki MoU.

General Allocation Fund (DAU)

The DAU has become the main source of revenue in Aceh after the decentralized system was introduced in 2001. From the national allocation, Aceh received Rp. 5 trillion in 2006 or around 3.4 percent of national share. The average contribution of DAU to total revenue in Aceh post-decentralization was 43 percent. In real terms, the allocation of DAU in Aceh experienced a decline in 2002 and 2003, but increased significantly in 2006 (Figure 3.18). The sharp increase in 2006 is in line with the beginning of implementation of an increase of national DAU allocation to 26 percent of domestic net revenue, and 100 percent coverage of civil service salaries as indicated in Law 33/2004.

Figure 3.18: DAU allocation trend for NAD (in constant 2005 prices)

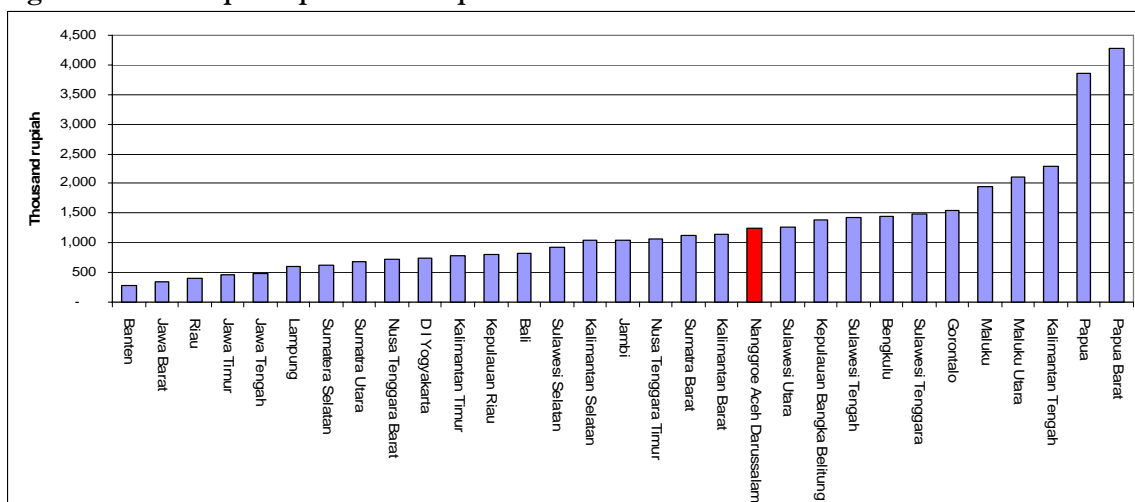


Source: World Bank staff calculations based data from MOF.

DAU formula was enhanced in 2002 when revenue sharing was included as part of calculating fiscal capacity. As a result, many resource-rich regions received less DAU than in the previous year. There were 10 local government in Aceh that received in 2002 the same DAU allocation than in 2001. The final allocation of DAU in 2002 was done under the basis of “hold harmless” condition.⁴⁹ The allocation of DAU in 2003, 2004, and 2005 followed more or less a similar concept and process with that of previous years. The only modifications were slightly different components used in the formula, or increased weights of some components (such as civil servants’ salaries).

Compared to other provinces in Indonesia, Aceh has benefited from higher DAU allocation as well as per capita distribution in 2006. In per capita terms, Aceh received Rp. 1.2 million, which is more than double the 2001 allocation (Figure 3.19).

Figure 3.19: DAU per capita 2006 for provinces in Indonesia

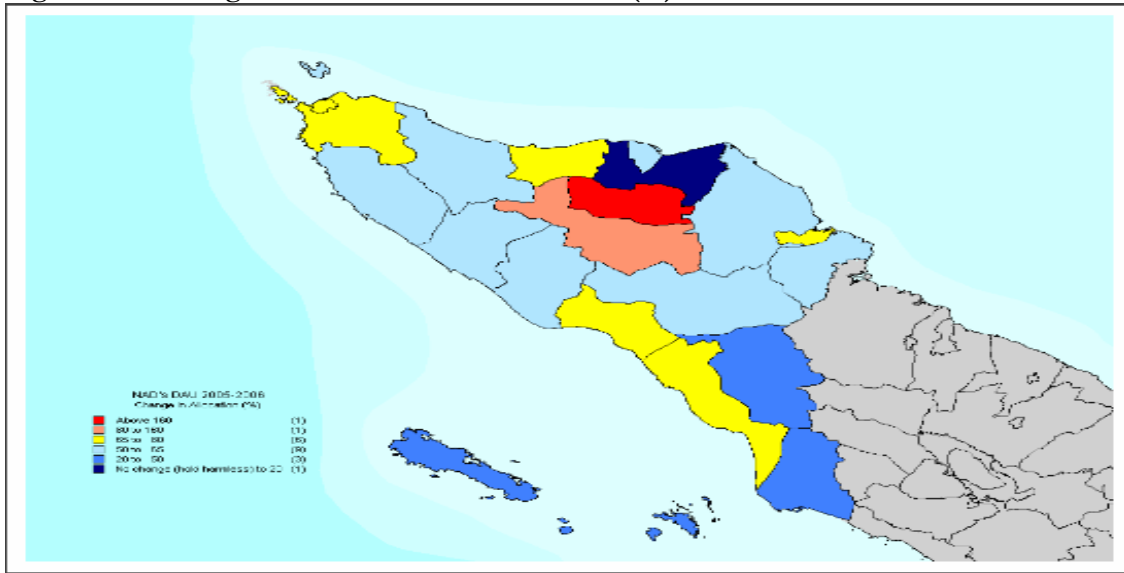


Source: World Bank staff calculation based on data from MOF.

All local government except for Aceh Utara received a large increase in DAU allocation in 2006. As a resource rich region, Kab. Aceh Utara only received hold harmless allocation in 2006, and thus has a zero increase. On average, the DAU allocation in Aceh increased by 67 percent in 2006 (Figure 3.20).

⁴⁹ Under “hold harmless” condition the province or local government will not receive an allocation lower than the previous year’s allocation.

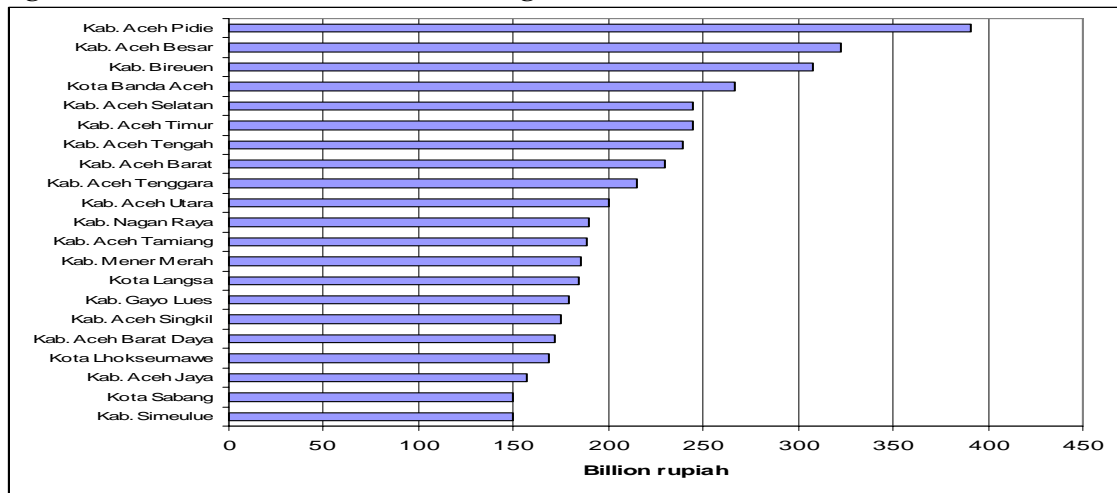
Figure 3.20: Change in DAU allocation, 2005-2006 (%)



Source: MoF and World Bank staff calculations.

Within Aceh, the allocation of DAU is varied among local government. Kab. Aceh Pidie receives the largest allocation of Rp. 390 billion, followed by Kab. Aceh Besar and Kab. Bireuen with more than Rp. 300 billion each. Despite its hold harmless allocation, Aceh Utara still receives substantial DAU resources (Figure 3.21).

Figure 3.21: DAU 2006 allocation for local government in Aceh



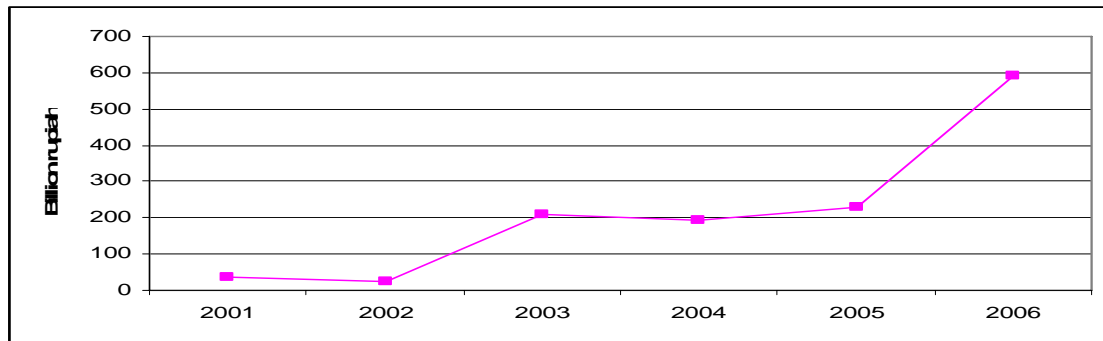
Source: World Bank staff calculations based on data from MOF. Data are in constant 2005 prices.

Special Allocation Fund (DAK)

The special autonomy Law 18/2001 granted Aceh priority in DAK allocation. DAK allocation has increased significantly but remains the smallest contributor to overall revenue. In 2006, Aceh receives DAK allocation in the amount of Rp. 593 billion or 15 times higher compared to what it

received six years ago. The allocation increased sharply in 2006, in part due to an expansion of the sectors included in DAK allocation..

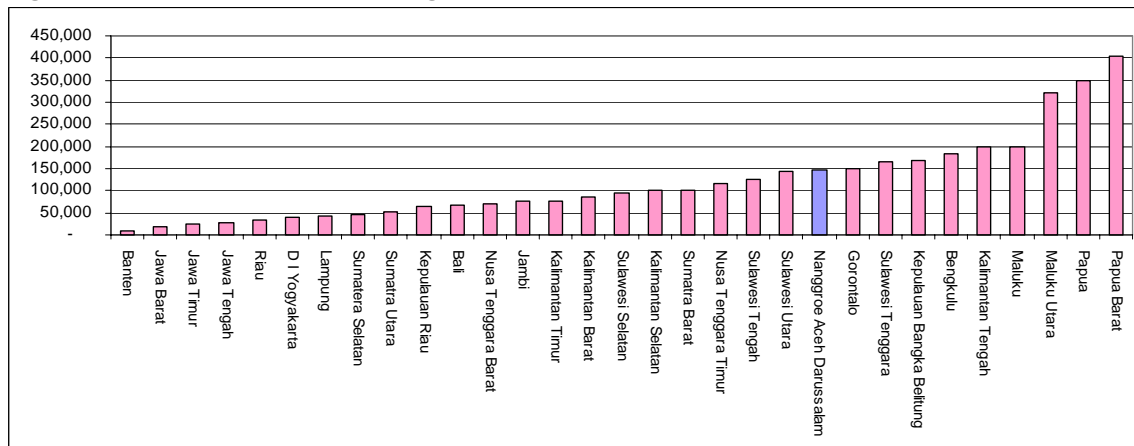
Figure 3.22: Trends of DAK allocation in NAD



Source: World Bank staff calculation based on data from MOF. Data are in real terms (constant 2005 prices).

In comparison with other provinces in Indonesia, Aceh is among the top 10 provinces in DAK allocation both in terms of absolute number and per capita figure. In 2006, Aceh received an allocation of Rp. 147,000 per capita (Figure 3.23).

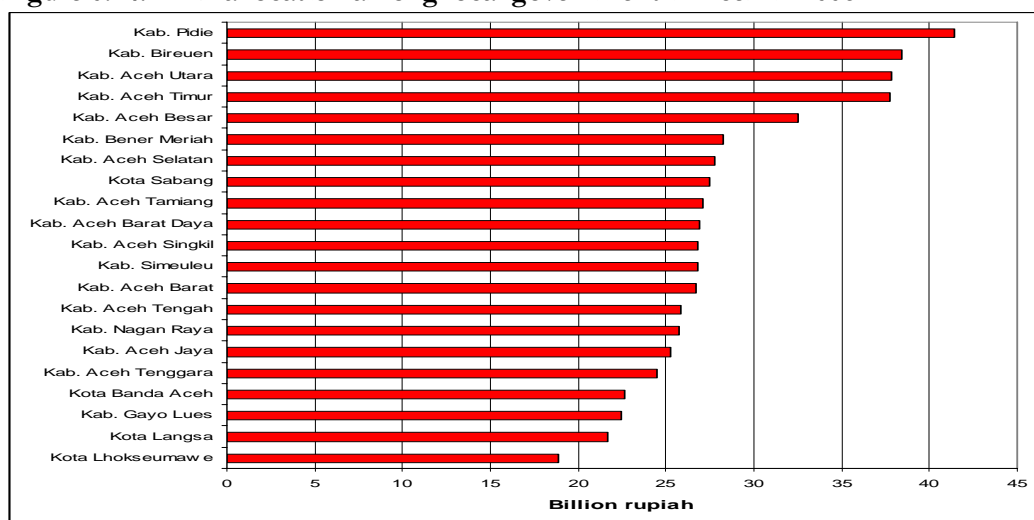
Figure 3.23: DAK per capita among provinces in Indonesia in 2006



Source: World Bank staff calculation based on data from MOF. Data are in real term (constant 2005 price)

Within Aceh, DAK allocation varies across *kabupaten/kota*. Kab. Pidie receives the highest allocation of more than Rp. 40 billion, followed closely by Kab. Bireuen, Kab. Aceh Utara, and Kab. Aceh Timur. The district with the lowest DAK allocation is Kota Lhokseumawe with less than Rp. 20 billion. There is a common element found in all *kabupatens* with the highest DAK allocation, which is that all of them are former conflict “hotspot” areas.

Figure 0.24: DAK allocation among local government in Aceh in 2006



Source: World Bank staff calculation based on data from MOF. Data are in constant 2005 price.

In 2001 and 2002, DAK was mainly used for reforestation activities.⁵⁰ Starting in 2003, DAK allocation has been expanded and covers several sectors including infrastructure, education, health, government facilities, agriculture, fisheries, and the environment. Since 2003, infrastructure has become the main focus of DAK, but allocation continued to decrease over the years. Infrastructure accounted for up to 50 percent of DAK-non reforestation funds in 2003 but declined to 30 percent in 2006. Education and health follow infrastructure, with an average of 25 and 18 percent respectively. In 2004, the fisheries sector has also received a share from DAK-non reforestation, and in 2006 agriculture accounts for 10 percent of DAK- non reforestation.

Deconcentration and Emergency Funds

Deconcentration funds can be considered revenue for the province and local government since the actual implementation of the program is in the region.⁵¹ This fund is delegated to the region in the form of development expenditures that do not cover routine/recurrent spending of vertical agencies in the region. Although the program is implemented by the province and local government, deconcentration fund is not recorded in the province and local government budget (APBD); instead, it is recorded in the national budget (APBN). The province and local government report their spending and are accountable directly to central government.

⁵⁰ Restoration funds are distributed 40 percent to producing regions, and 60 percent to central government to do reforestation activities all over the country, particularly in natural resources non-producing regions.

⁵¹ Deconcentration fund is central government development spending in the region (from APBN) carried out by the province or local government as a part of line ministries work program. The main objective is to finance central government functions and activities related to national priorities using two different mechanisms: deconcentration (*dekonsentrasi*) and assistance tasks (*tugas pembantuan*). With deconcentration mechanism, the province may be assigned to perform central government functions in the region. Under assistance tasks mechanism, central government may delegate its function to be undertaken by all levels of regional government (province, local government, and village). In our analysis we assume that deconcentration funds include both deconcentration and assistance tasks since both allocations are spent in the region regardless of the implementing agency. In fact, the separate data of both spending is not available.

The share of deconcentration and emergency funds to total revenue in Aceh decreased from 57 percent in 1999 to about 15 percent in 2002, and it has stayed at this level since then (Table 3.8). The observed slight variations since 2002 can be explained by the increase in Aceh's regional own-source revenue.

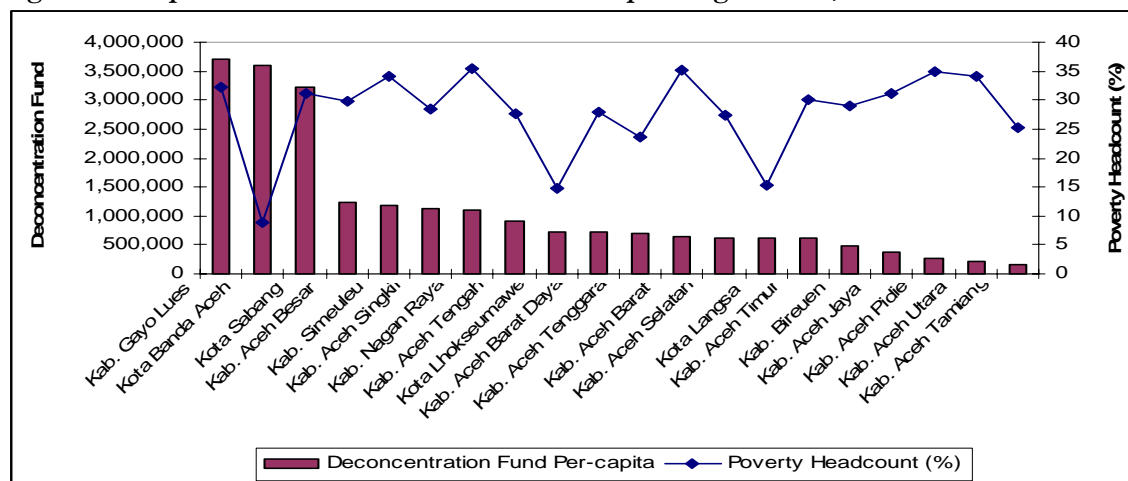
Table 3.8: Share of deconcentration fund to total regional revenue

Revenue	1999		2001		2002		2003		2004		2005	
	RphBillion	%	RphBillion	%	RphBillion	%	RphBillion	%	RphBillion	%	RphBillion	%
Subnational Revenue	1,966	43.3	5,222	77.2	7,028	85.1	8,163	82.7	8,414	86.7	7,323	82.9
Deconcentration Funds	2,563	56.7	1,546	22.8	1,227	14.9	1,713	17.3	1,292	13.3	1,511	17.1
Total Regional Revenue+Deconcentration Fun	4,519	100	6,768	100	8,253	100	9,876	100	9,706	100	8,834	100

Source: World Bank Staff calculation based on data from SIKD/MOF and BAPPEDA NAD. Data are in real terms (constant 2005 price).

The allocation of deconcentration funds in Aceh is somewhat ambiguous with regard to inequality and prioritization for lagging regions. On one hand, the newly established Kab. Gayo Lues (the sixth poorest *kabupaten*) received the highest per-capita allocation. On the other hand, the areas closer to the capital city Banda Aceh, Kab. Aceh Besar and Kota Sabang, ranked in the top five per capita allocations. It is plausible that this high per capita allocation reflects the fact that these three local governments have more major “central” infrastructures, such as a national port and government buildings. At the same time, Kab. Simeule (an island located on the west coast of Aceh) has almost four times lower per capita allocation than Kab. Aceh Besar. The poorest *kabupaten*, Nagan Raya, received three times lower per capita allocation than Kota Banda Aceh which has the lowest poverty headcount in Aceh (Figure 3.25).

Figure 3.25: Spatial allocation of deconcentration spending in Aceh, 2004⁵²



Source: World Bank Staff calculation based on data from BAPPEDA NAD and BPS. Data are in real terms (constant 2005 price).

Another source of revenue for the province and local government is the emergency fund. Similar to the deconcentration fund, the emergency fund is categorized as regional government revenue since the actual spending is carried out in the region. This fund is made available from the national budget (APBN) and is provided to the provincial and local governments for emergency needs and in emergency situations. Central government allocates 5 percent of national annual budget to the emergency fund. Law 33/2004 defines national-scale natural disasters or

⁵² About 50 percent of deconcentration fund is carried out by the province and cannot be disaggregated by local government. The data used in the figure are those funds that were allocated to local government only.

solvability crisis as emergency needs. The president declares a natural disaster to be a national natural disaster (e.g., December 26, 2004 tsunami), while solvability crises at the provincial and local government are evaluated by the central government and the parliament. In Aceh, the province and local government budget show no record of emergency funds on their revenue accounts. It is most likely that central government spent the budget directly in the region through the national emergency board (e.g., BAKORNAS), and thus this amount was not recorded in the regional budget. In response to the tsunami, the central government set up the BAKORNAS in Aceh and provided financial assistance through it during the emergency relief period before the Rehabilitation and Reconstruction Agency (BRR) was established.

Revenues related to the peace process

The signing of the Helsinki MoU included a provision for funds to flow to Aceh to support the peace process. Following the peace accord, the central government disbursed Rp. 200 billion⁵³ (US\$ 21.5 million)⁵⁴ to strengthen the peace process in Aceh in 2005, and has pledged Rp. 600 billion (US\$ 64.5 million) in APBN 2006. The money was allocated mainly to support the reintegration process, particularly to help ex-combatants return to the community. The Office of the Vice President, Republic of Indonesia also allocated Rp. 50 billion (US\$ 5.4 million) to support the reintegration process in 2005. In addition, the European Commission (EC) has provided 4 million euros⁵⁵ (US\$ 5.2 million) under its Rapid Reaction Mechanism, to help with re-integration into civilian life of the former political prisoners and ex-combatants.

The European Commission also allocated funds in relation to the Aceh Monitoring Mission (AMM), established in September 2005 to sustain the reintegration process as well as monitor the implementation of the MoU. EC donated 8.5 million euros⁵⁶ (US\$ 11.6 million) to finance the immediate reintegration needs of former combatants and amnestied prisoners, as well as to provide support throughout Aceh to communities receiving ex-combatants. On December 20, 2005 EC approved an additional 15.9 million euros⁵⁷ (US\$ 22.2 million) of assistance for Aceh in support of the ongoing peace process. A series of programs financed by donors and NGOs are also assisting to sustain the peace process in Aceh (UNDP, IOM, etc.). However, most of these programs do not use government financial systems to channel those funds. The pledges of funds targeting reintegration needs, and their sources, are shown in Table 3.9 .

⁵³ *Republika*, 6 Feb 2006. Wapres Tagih Nama 3000 Anggota GAM. At http://www_republika_co_id.htm.

⁵⁴ Using the exchange rate of Rp. 9,300 per US\$ 1.

⁵⁵ European Union, September 2005. Aceh: Commission releases €4 million to support the peace process. At With currency €1 = Rp. 13,000

⁵⁶ European Union, September 2005. CFSP Action Profile. At http://ec.europa.eu/comm/external_relations/cfsp/fin/actions/ap_am_2005.htm

⁵⁷ European Union, Press Release, 20 December 2005, European Commission provides additional €15.85 million assistance for Aceh peace process. At <http://www.delidn.cec.eu.int/en/newsroom/2005-PI13EN.pdf>

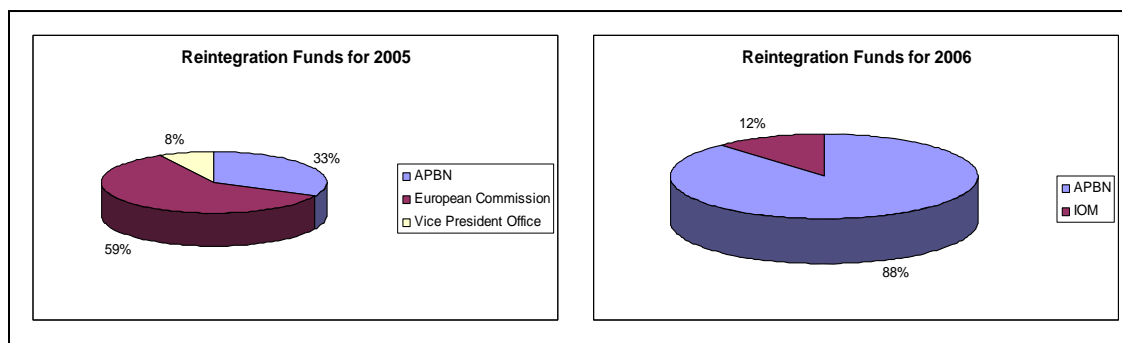
Table 3.9: The pledges of the Aceh reintegration fund for 2005 and 2006 (US\$ Million)

No	Programs	2005	2006	Total	Source
1	To shepherd ex combatants to community	21.5	64.5	86	APBN
2	Rapid Reaction Mechanism	5.2		5.2	European Commission
3	Reintegration process	5.4		5.4	Office of Vice President
4	Reintegration process through AMM (September 15, 2005)	11.6		11.6	European Commission
5	Additional fund for supporting and maintaining the peace process, democratization, and law enforcement in Aceh (December 20, 2005)	22.2		22.2	European Commission
6	Livelihood program for ex-prisoner and former combatants (2 March 2006)		8.6	8.6	IOM
	Total	65.9	73.1	139	

Source: compiled by World Bank staff using various sources.

Both central and provincial governments have pro-actively participated in strengthening of the peace process in Aceh. On February 11, 2006, the Governor of Aceh established a reintegration agency, *Badan Reintegrasi Aceh* (BRA). The agency is focused on providing economic empowerment assistance to GAM returnees and compensation to conflict victims. This is currently being done using a mechanism by which groups of GAM returnees submit proposals for economic empowerment assistance and village heads identify conflict victims. The commitment of Government of Indonesia to implementing the Helsinki MoU in Aceh can be easily tracked in the budget allocation for reintegration. Of the total reintegration budget for 2005 (US\$ 65.9 million), Government of Indonesia (APBN plus the Vice President Office) shared 41 percent. For 2006, APBN shares 88 percent of the total US\$ 73.1 million reintegration budget (Figure 3.26).

Figure 3.26: Composition of the reintegration funds in Aceh, 2005 and 2006



Source: various data.

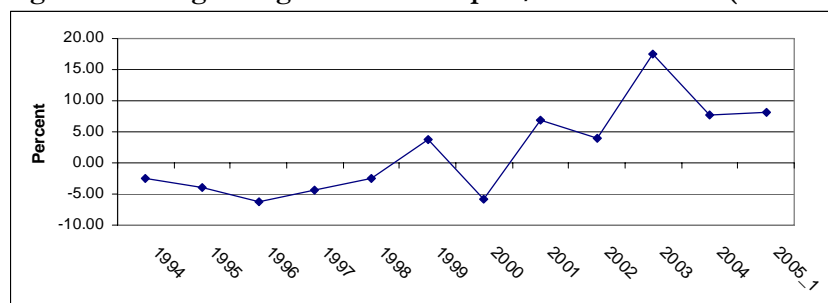
Financing and Borrowing

Under the old budget format, the analysis of financing is conducted by calculating the net budget surplus and deficit.⁵⁸ Prior to decentralization, local government in Aceh, as most local

⁵⁸ Net budget surplus/deficit does not take into account loan, repayment, and carry-over from previous year as well as into following year.

governments in Indonesia, had generated budget deficits for most of the years, except in 1999 when local government in Aceh succeeded to accumulate a small surplus. On average, local government in Aceh ran a deficit of 4 percent to total expenditure during 1994 to 1998 (Figure 3.27).

Figure 3.27: Regional government surplus/deficit in Aceh (% of total expenditure)⁵⁹



Source: Ministry of Finance and World Bank staff calculations.

After fiscal decentralization regional government in Aceh has generated a substantial surplus. The surplus reached about Rp. 1 trillion in 2005. As for local government, it has also generated substantial surpluses until 2005 when it experienced a deficit of about 8 percent.⁶⁰ It is believed that local governments put aside their budget for post-tsunami reconstruction, especially to finance the reconstruction of government building and infrastructure. Despite the deficit in local government budget in 2005, the overall provincial and local government in Aceh has accumulated significant reserves of Rp. 3 trillion by the end of 2005 (Table 3.10).⁶¹

Table 3.10: Budget surplus/deficit and reserves of the regional government in Aceh

	2001	2002	2003	2004	2005*
Province	27,801,804,107	202,477,118,628	639,709,882,553	365,548,410,053	949,799,237,813
Kab/kota	312,832,679,826	66,938,204,652	572,309,286,029	233,699,343,081	(397,404,101,272)
Total province & kab/kota	340,634,483,933	269,415,323,280	1,212,019,168,582	599,247,753,135	552,395,136,541
Reserves end of period	340,634,483,933	610,049,807,213	1,822,068,975,794	2,421,316,728,929	2,973,711,865,470

Source: Ministry of Finance and World Bank staff calculations.

Note: * - Planned budget figure.

Law 33/2004 allows regional governments to borrow directly from domestic sources and indirectly from international sources upon approval from the Ministry of Finance. The sources of domestic loans come from central government, other regional governments, banks, non-bank institutions, and placement of regional bonds. The government regulation on regional borrowing (PP 54/2005) provides a set of arrangements on borrowing limits and conditions for the regional government. On the limit, cumulative borrowing from central and regional government may not exceed 60 percent of current regional GDP.⁶² On the borrowing conditions, regional government has to follow the following requirements: (1) the cumulative regional borrowing does not exceed 75

⁵⁹ Regional government refers to provincial and local government government.

⁶⁰ The 2005 data are planned data.

⁶¹ The accumulation of reserves is often caused by delays in transferring oil and gas revenue sharing from central government, which slows the project implementation and disbursement. The amounts not disbursed appear as a surplus in province budget and are carried over to the next fiscal year.

⁶² Cumulative borrowing of central and regional government is the total borrowing of central government less the loans given to regional government, plus the total borrowing of regional government less the loans given by central government or other regional governments.

percent of total general budget revenue of the previous year, (2) debt service coverage ratio (DSCR) is at least 2.5 percent, (3) there are no arrears on the borrowing made by the government, and (4) borrowing is approved by regional parliament. In addition to loans, Law 11/2006 stipulates that Aceh's government is eligible to receive unconditional grants from international sources with acknowledgement of central government and regional parliament.

Aceh's provincial government has had a borrowing history since 1981. Local governments that have borrowing records are Aceh Barat, Aceh Selatan, Aceh Tengah, Aceh Tenggara, Aceh Timur, Aceh Utara, and Banda Aceh. The 2004 data from the Ministry of Finance shows that local government in Aceh had larger borrowing transactions compared to provincial government with most transactions made by the local government PDAM.⁶³ However, there were no borrowing transactions made by provincial PDAM. Around 55 percent of total borrowing was made by the regional government while the rest 45 percent was made by PDAM (Table 3.11).

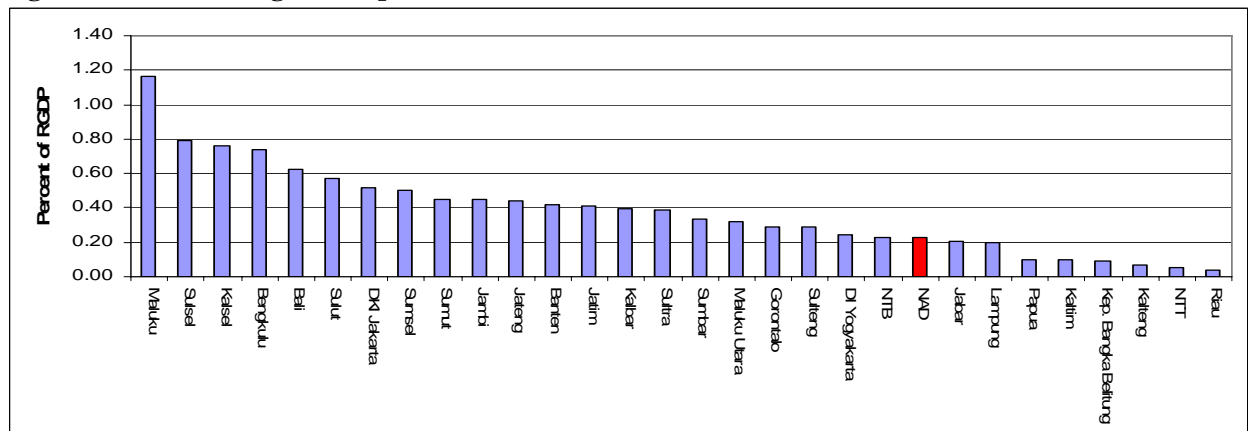
Table 3.11: Borrowing record of regional government and PDAM in Aceh 2004

	Amount borrowed	Payment due	Total arrears	Total outstanding
Government				
Province	24,165,000,000	46,378,560,000	36,396,730,469	17,048,330,000
Kab/kota	25,349,160,000	64,517,550,000	43,736,590,577	11,093,070,000
Total government	49,514,160,000	110,896,110,000	80,133,321,046	28,141,400,000
PDAM				
Province	0	0	0	0
Kab/kota	40,739,920,000	50,152,850,000	49,646,030,000	40,739,550,000
Total PDAM	40,739,920,000	50,152,850,000	49,646,030,000	40,739,550,000
Total	90,254,080,000	161,048,960,000	129,779,351,046	68,880,950,000

Source: Ministry of Finance

Aceh government needs to start paying more attention to its borrowing transactions as the total borrowing amount has increased quite significantly since 2001. The borrowing amount has increased from Rp. 55 billion in 2001 to Rp. 90 billion in 2004. The increase solely comes from local government, since there is no increment in the amount that the province is borrowing. Although there is a tendency for increasing borrowing, the accumulated borrowing amount for Aceh is below that of many other provinces in Indonesia, and below the national average (Figure 3.28).

Figure 3.28: Borrowing across provinces in Indonesia as % of GDP, 2004

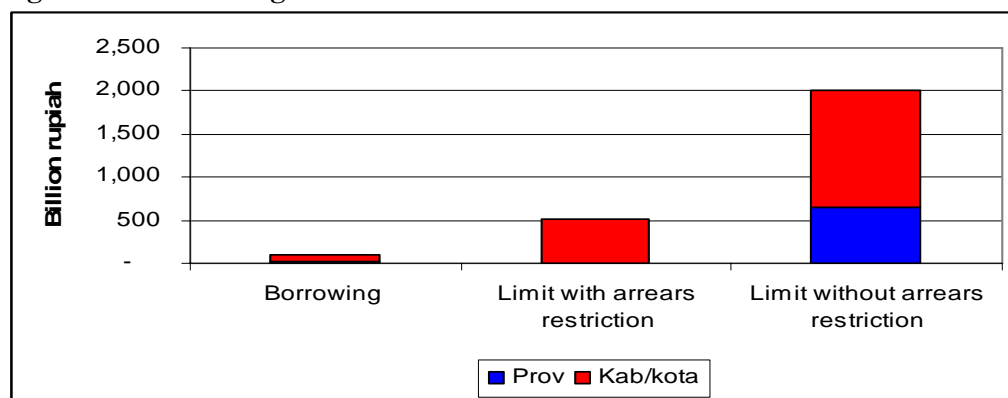


Source: Ministry of Finance and World Bank staff calculations.

⁶³ PDAM stands for *Perusahaan Daerah Air Minum*, which is a provincial/local government owned firm.

To anticipate the tendency for a larger amount of loans in the future, it is important that the regional government takes into account the conditions set by the law on borrowing limitations. A simulation on borrowing limitations shows that if arrears are taken into consideration none among the local government in Aceh that has a borrowing record can have another borrowing transaction. The limitation on arrears has a significant impact on the borrowing limit (Figure 3.29). However, even with the restrictions on arrears local governments in Aceh can still borrow up to Rp. 500 billion in total.⁶⁴

Figure 3.29: Borrowing limitation with and without arrears' restriction for Aceh



Source: World Bank staff calculations.

Recommendations

Develop a better coordination between the province, local government, BRR, and BRA in managing reconstruction, reintegration, and long-term development. Fiscal decentralization and special autonomy have improved fiscal capacity of the province and local government in Aceh by more than six times compared to before decentralization. In addition, the massive financial inflow from inside and outside the country to finance the reconstruction and reintegration process increased the total revenue by more than 15 times compared to what it received in 1999. An integrated and coordinated development program can enhance the implementation and address the geographic and sectoral gaps among local government in Nangroe Aceh Darussalam

Improve transparency and accountability on the allocation and distribution of special autonomy fund. There has been a concern in Aceh that the calculation and allocation of special autonomy fund from central government lacked transparency. Regional government does not have access to detailed information on oil and gas production and costs related to exploration. In addition, the province often experienced delays in receiving the transfer of special autonomy fund from the center, with consequent delays in transferring it to Local government. These delays might have disturbed their financial management and cash flow as well as disrupted development programs.

Transfer the major control of special autonomy fund to local government. The current arrangement granted the province 40 percent of the special autonomy fund. Local government should receive higher share of special autonomy fund, since they are the one who perform major public service functions. The provincial government is better focusing on monitoring and evaluation as well as enforcement to ensure that the use of special autonomy fund is in line with the objective and comply with the regulation.

⁶⁴ Local government with high arrears record would be precluded from borrowing.

Improve the capacity of local government in managing and recording the special autonomy fund in their budget (APBD). This might improve financial management capacity and transparency of local government in managing and spending special autonomy fund. In the past, local government inconsistently recorded special autonomy fund in their budget.

Improve own-source revenue mobilization of local government by identifying potential taxes and charges that fulfill “good tax criteria” and also optimizing the revenue from land and building tax. In addition, the province should provide guidance over tax administration of the splitting local government. Clear assignment and management of tax sources can improve tax collection and accountability. Improving own-source revenue mobilization is important since the future revenue from special autonomy fund is projected to sharply decrease.

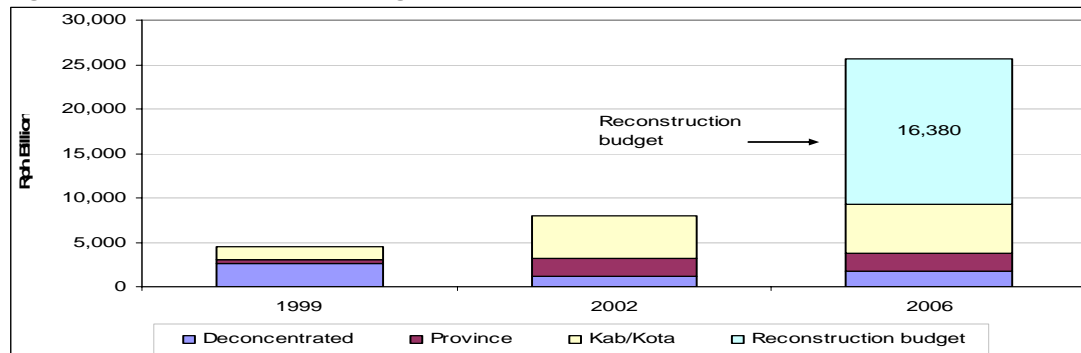
4. EXPENDITURES

The overall picture of expenditures in Aceh

The regional share in government spending in Indonesia has increased to over 30 percent following decentralization. This increase reflected the transformation of major service delivery functions and transfer of approximately two third of central government work force to the region. In the past, the regional government managed only 17 percent of total expenditure spent in the region. A large share of expenditure was managed and implemented by the representative line agencies of central government in the region.

Overall public spending in Aceh has increased significantly in recent years. This increase was driven by additional revenue gained from intergovernmental transfer after decentralization and from an additional oil and gas revenue sharing from special autonomy provisions. In addition, public spending in Aceh is anticipated to increase substantially in the next five years due to reconstruction efforts after the tsunami. Including reconstruction financing, total spending reaches more than Rp. 25 trillion (Figure 4.1). If the resources are managed and spent effectively, there is a huge opportunity for the Acehnese to boost the region's economic development.

Figure 4.1: Aceh public spending pre- and post-decentralization, and after tsunami



Source: World Bank staff calculations based on data from SIKD/MoF, BPS-SK/BPS and BRR. The provincial and local governments' budgets for 2006 are projected using average growth after decentralization. Data are in real terms (constant 2005 prices).

In 2004, the provincial and local government in Aceh had spent more than Rp. 7.5 trillion and managed an additional allocation from line ministries of Rp. 1.3 trillion. The total regional expenditure more than doubled compared to its level in the mid-1990s.

Both provincial and local government spending has increased after the 1999 decentralization and the 2001 special autonomy, which resulted in significant revenue windfall.⁶⁵ Provincial government spending more than quintupled by 2004 compared to pre-decentralization levels. Local government spending also more than tripled during that period (Table 4.1). Despite the significant resources inflow, the growing number of local governments might have an impact on a higher regional spending in Aceh.⁶⁶

⁶⁵ The 1999 decentralization became effective (i.e., reflected in increased revenues) in 2000, and the 2001 special autonomy status became effective in 2002.

⁶⁶ Number of local government in Aceh has been growing after decentralization. In 2004, Aceh had almost doubled number of local government (21 local government) compared to its pre-decentralization (11 local government).

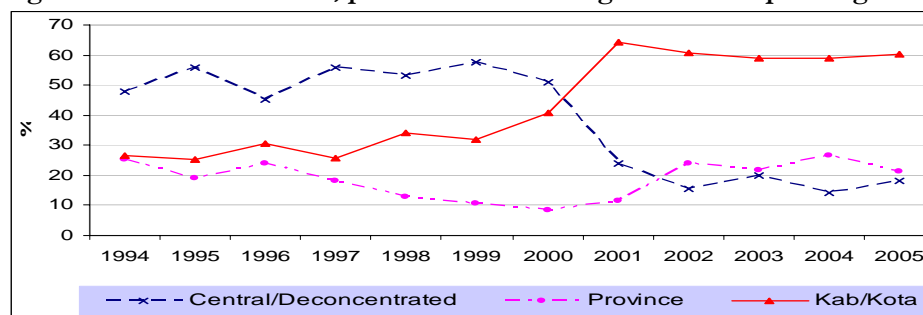
Table 4.1: Aceh overall public expenditure pre- and post-decentralization

Year	Deconcentrated		Province		Kab/Kota		Total (Rph Billion)
	Rph Billion	%	Rph Billion	%	Rph Billion	%	
1994	1,859.2	48.0	978.9	25.3	1,034.4	26.7	3,872.6
1995	2,804.9	55.9	946.6	18.9	1,261.8	25.2	5,013.3
1996	1,924.5	45.3	1,016.5	24.0	1,302.8	30.7	4,243.8
1997	3,160.7	56.0	1,026.1	18.2	1,458.4	25.8	5,645.3
1998	1,797.2	53.3	432.5	12.8	1,144.8	33.9	3,374.5
1999	2,563.2	57.6	470.2	10.6	1,416.0	31.8	4,449.4
2000	2,676.4	50.9	435.4	8.3	2,146.8	40.8	5,258.6
2001	1,545.8	24.1	747.0	11.6	4,134.5	64.3	6,427.3
2002	1,227.2	15.4	1,906.1	23.9	4,851.0	60.8	7,984.3
2003	1,712.5	19.8	1,862.7	21.5	5,088.0	58.7	8,663.2
2004	1,291.7	14.2	2,435.2	26.7	5,379.5	59.1	9,106.4
2005	1,510.8	18.2	1,772.6	21.4	4,998.4	60.4	8,281.8

Source: World Bank staff calculations based on data from SIKD/MoF and BPS-SK/BPS. Data are in real terms (constant 2005 prices).

There has been a significant transformation in the division of public spending in Aceh between the central and regional governments. Before decentralization, the central government played an important role in regional development. In 1999, almost 60 percent of spending was carried out by the central government, leaving a limited role for regional government in providing service delivery and regional development. The planning and budgeting process started upon approval from the central government. After decentralization, provincial and local governments had greater authority over their budget allocations. On average, regional governments in Aceh have been managing more than two-thirds of total public spending. Local government is now managing more than 60 percent of public spending and almost 20 percent of total expenditure is carried out by the province (Figure 4.2).

Figure 4.2: Share of central, provincial and local government spending in Aceh



Source: World Bank staff calculations based on data from SIKD/MoF and BPS-SK/BPS. Data are in real terms (constant 2005 prices).

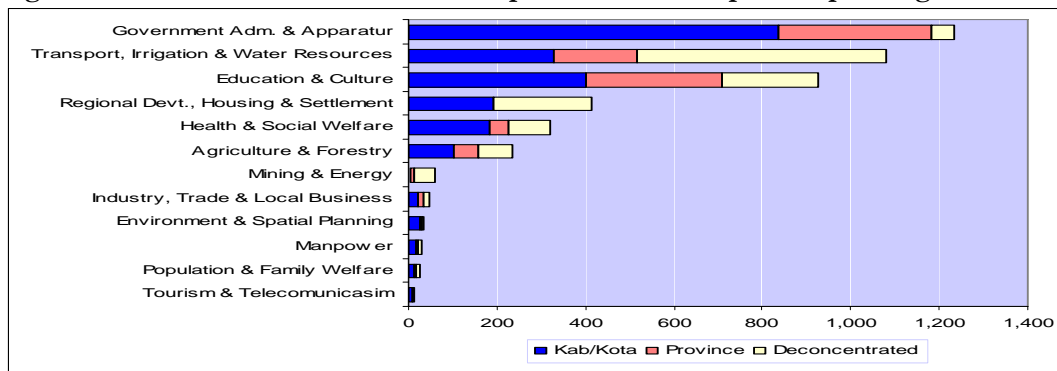
The special autonomy status increased the power of the province in controlling regional government financing. The revenue from special autonomy is transferred directly from the center to the province and from the province to local government. In 2002, as total spending by provincial government almost tripled compared to the 2001 level, the share of provincial government spending in total fiscal outlays increased to about 25 percent.

Despite a decreased role in regional spending after decentralization, the central government continues to expend substantial resources in the region. Central government spending is intended to support its representative office and to finance projects that are classified as national priority. In 2003, the central government alone contributed more than 30 percent to development spending. The data indicates that the central government continues to spend on largely decentralized functions.

The central, provincial and local governments have similar spending patterns. The central government has spent mainly on five sectors that are by and large also prioritized by regional government: infrastructure, education, regional development, health, and agriculture (Figure 4.3). Beyond these five sectors, the provincial and local governments focused spending on government administration and apparatus.

Two main decentralized functions, education and health, have been predominately the responsibility of local government. However, the central and provincial governments also spent almost equal shares on education and health sectors. Future spending by the central government on largely decentralized functions should not be encouraged since regional governments have better understanding of regional priorities and since that would help avoid overlapping and inefficiency in budget allocation.

Figure 4.3: Sectoral and institutional composition of development spending in Aceh, 2004



Source: World Bank staff calculations based on data from BPS-SK/BPS and SIKD/MOF. Data are in real terms (constant 2005 prices).

Routine vs. Development Expenditure, and New Budget Format

Prior to decentralization, almost 70 percent of provincial government expenditure went toward routine budget. Much of this spending was due to provincial government responsibility for paying the salaries of civil servants. In 2002, as Aceh received a significant amount of additional resources from special autonomy, the share of development spending in the total province expenditure increased substantially. However, routine expenditure has been on the rise again. Currently, routine and development spending make up about 50 percent each at both the provincial and local government levels (Figure 4.4).

Figure 4.4: Share of Province's Expenditure

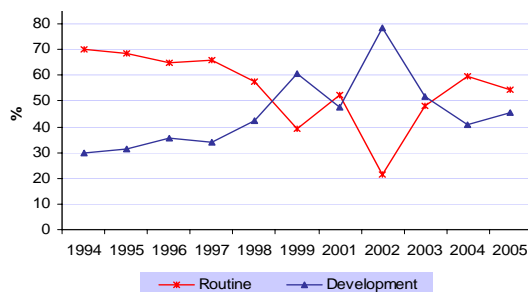
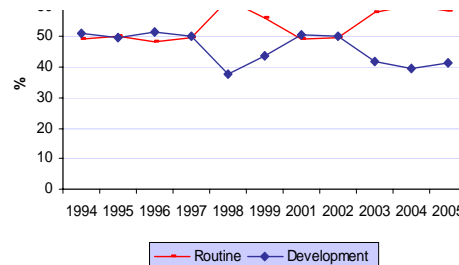


Figure 4.5: Share of Local government's Expenditure



Source: World Bank staff calculations based on data from SIKD/MoF and BPS-SK/BPS. Data are in real terms (constant 2005 prices).

Similarly, local government has historically spent somewhat more on routine expenditure before decentralization, and will likely continue to do so in the coming years. In 2004, local government spent almost 60 percent of its spending on routine expenditure (Figure 4.5). The high share of routine spending is partly due to civil servants salaries having been transferred to local governments after decentralization. In addition, the growing number of local governments after decentralization has also contributed to the increase in spending on administrative affairs.

Routine expenditure has increased more than four times from pre-decentralization levels. Spending on personnel registered the strongest increase after decentralization, making up to 53 percent in 2004 (down from around 75 percent in 2001) (Table 4.2). The share of financial assistance and unexpected expenses increased noticeably since 2003.

Table 4.2: Structure of regional routine expenditure

Routine Expenditure	1999		2001		2002		2003		2004		2005	
	Rph Billion	%	Rph Billion	%	Rph Billion	%	Rph Billion	%	Rph Billion	%	Rph Billion	%
Personnel	666.4	68.0	1,806.5	74.1	1,894.3	66.9	2,262.5	58.6	2,498.7	53.2	2,166.4	55.7
Goods & Services	98.4	10.0	227.6	9.3	324.4	11.5	358.1	9.3	402.7	8.6	416.7	10.7
Operational & Maintenance	22.4	2.3	48.1	2.0	94.0	3.3	93.2	2.4	80.7	1.7	73.5	1.9
Official Travel	17.8	1.8	30.4	1.2	42.2	1.5	70.2	1.8	67.3	1.4	84.3	2.2
Others	88.1	9.0	124.3	5.1	225.6	8.0	21.3	0.6	0.0	0.0	0.0	0.0
Financial Assistance & Unexpected E	86.2	8.8	199.7	8.2	250.7	8.9	1,055.4	27.3	1,645.5	35.0	1,150.2	29.6
Total	979.3	100.0	2,436.4	100.0	2,831.2	100.0	3,860.6	100.0	4,694.8	100.0	3,891.2	100.0

Source: World Bank staff calculations based on data from SIKD/MoF and BPS-SK/BPS. Data are in real terms (constant 2005 prices).

The regional development expenditure in Aceh has also increased by more than four times between 1999 and 2002, with a decreasing trend in 2003 and 2004. This decrease could at least in part be explained by the intensification of the conflict starting 2003.⁶⁷ There have been some changes in sectoral allocation of development expenditure between pre- and post-decentralization. Although government apparatus, infrastructure, and education remain the highest priority for regional government, after the decentralization the share of the development budget spent on the former two categories increased, while the share of infrastructure spending declined (Table 4.3).

Pre-decentralization, regional government invested mostly in infrastructure development. After decentralization, although the spending on infrastructure increased in real terms, it declined as a share of total spending. Pre-decentralization, almost 50 percent of development budget was allocated for improving regional development through building roads, as well as irrigation and sanitation systems. The volume of infrastructure spending in real terms has increased from Rp. 452 billion in 1999 to Rp. 1,211 billion in 2002. However, the share of infrastructure spending declined from 50 percent to 31 percent during that period (Table 4.3).

⁶⁷ The 2003 and 2004 data have been adjusted, following the change in local government budget format, in accordance with routine and development categories; however, there might still be substantial data errors.

Table 4.3: Regional development expenditure by sector

Sector	1999		2000		2001		2002		2003		2004		2005	
	Rph Billion	%	Rph Billion	%	Rph Billion	%	Rph Billion	%	Rph Billion	%	Rph Billion	%	Rph Billion	%
Government Apparatus	112.1	12.4	227.1	14.7	325.7	13.3	806.9	20.6	921.5	29.8	1,181.4	37.9	999.8	34.7
Agriculture	52.6	5.8	67.7	4.4	231.3	9.5	173.0	4.4	174.9	5.7	159.5	5.1	163.3	5.7
Mining and Energy	2.3	0.3	12.0	0.8	4.6	0.2	8.5	0.2	13.4	0.4	13.2	0.4	10.1	0.4
Industry and Trade	31.2	3.4	49.5	3.2	223.3	9.1	251.8	6.4	47.2	1.5	35.6	1.1	41.6	1.4
Labor Force	0.2	0.0	6.2	0.4	4.0	0.2	6.6	0.2	13.2	0.4	22.5	0.7	19.4	0.7
Health, Social Welfare	108.8	12.0	126.0	8.1	208.7	8.5	255.7	6.5	214.5	6.9	228.3	7.3	191.8	6.7
Education and Culture	112.7	12.4	145.9	9.4	398.9	16.3	1,084.2	27.6	855.3	27.7	709.4	22.7	603.4	21.0
Environment & Spatial Planning	31.9	3.5	36.6	2.4	67.3	2.8	121.9	3.1	21.9	0.7	31.0	1.0	32.8	1.1
Family Planning & Demography	2.6	0.3	6.2	0.4	4.7	0.2	6.1	0.2	5.6	0.2	18.6	0.6	10.4	0.4
Infrastructure	452.6	49.9	871.1	56.3	976.6	39.9	1,211.3	30.9	822.6	26.6	720.3	23.1	807.0	28.0
Transport, water and Irrigation	282.9	31.2	440.2	28.4	630.0	25.8	681.0	17.3	641.5	20.8	517.1	16.6	696.2	24.2
Tourism & Telecommunication	8.4	0.9	5.2	0.3	17.4	0.7	22.0	0.6	9.0	0.3	10.5	0.3	7.8	0.3
Housing and Settlement	161.3	17.8	425.7	27.5	329.1	13.5	508.3	12.9	172.1	5.6	192.8	6.2	103.0	3.6
Total	906.9	100.0	1,548.3	100.0	2,445.1	100.0	3,925.9	100.0	3,090.1	100.0	3,119.9	100.0	2,879.8	100.0

Source: World Bank staff calculations based on data from SIKD/MoF and BPS-SK/BPS. Data are in real terms (constant 2005 prices).

Since 2003, development spending on government apparatus has become the highest spending priority for provincial and local government. The share of this sector in total development expenditure has continuously increased from about 12 percent in 1999 to almost 40 percent in 2004. The increasing number of local governments is likely to have contributed to the increase in spending on government infrastructure and supervision.

In 2002, a new concept of performance-based budgeting was introduced, and the government budgeting format was unified with a view of a more integrated approach to expenditure management.⁶⁸ The new budget format is characterized by a shift from a distinction between routine and development (program/project-based approach) spending toward the distinction between expenditure on the government apparatus and expenditure on public services (beneficiaries approach). The new budget format was widely adopted by regional government in Aceh in 2003. The provincial and local governments reporting their budget to Ministry of Finance all used the new budget format. This transformation enables the evaluation of how much spending the regional government allocated to the projects that benefited the public and government apparatus.

In general, regional government in Aceh spent more on public services. In 2003, the provincial and local governments allocated more than 50 percent of their budget to public services (Table 4.4). The share as well as the total allocation on public services declined in 2004. The provincial and local government allocated slightly more than 30 percent on apparatus expenses.

⁶⁸ These changes were stipulated in the Ministry of Home Affairs Decree 29/2002 (Kepmen 29).

Table 4.4: Composition of regional spending based on new budget format (apparatus and public services)

Expenditure	2003						2004					
	Province		Kab/Kota		Total		Province		Kab/Kota		Total	
	Rph Billion	%	Rph Billion	%	Rph Billion	%	Rph Billion	%	Rph Billion	%	Rph Billion	%
Apparatur Expense	446.0	23.9	1,772.0	34.9	2,218.0	31.9	489.4	20.1	1,703.3	40.7	2,192.7	33.1
General Administration	292.3	15.7	1,327.9	26.1	1,620.2	23.3	307.5	12.6	1,230.6	29.4	1,538.1	23.2
Capital	69.8	3.7	209.3	4.1	279.0	4.0	64.5	2.6	171.5	4.1	236.0	3.6
Operational & Maintenance	84.0	4.5	234.8	4.6	318.8	4.6	117.3	4.8	301.3	7.2	418.6	6.3
Public Expense	836.3	44.9	2,825.5	55.6	3,661.9	52.7	822.9	33.8	2,116.6	50.6	2,939.5	44.4
General Administration	26.9	1.4	1,142.7	22.5	1,169.6	16.8	16.9	0.7	786.5	18.8	803.4	12.1
Capital	371.2	19.9	844.3	16.6	1,215.5	17.5	369.1	15.2	674.5	16.1	1,043.5	15.8
Operational & Maintenance	438.2	23.5	838.6	16.5	1,276.8	18.4	437.0	17.9	655.6	15.7	1,092.5	16.5
Unexpected Expenses	3.4	0.2	117.3	2.3	120.7	1.7	2.3	0.1	75.3	1.8	77.6	1.2
Financial Assistance & Sharing Exp	577.0	31.0	368.6	7.3	945.6	13.6	1,120.7	46.0	286.8	6.9	1,407.5	21.3
Total	1,862.7	100.0	5,083.4	100.0	6,946.1	100.0	2,435.2	100.0	4,182.0	100.0	6,617.3	100.0

Source: World Bank staff calculations based on data from World Bank Decentralization Database and SIKD/MOF. Data are in real terms (constant 2005 prices).

As in other regions in Indonesia, local government in Aceh is not always able to realize expenditure as planned. The realization of both development and routine spending is lower than the budgeted one. Aceh's local government under-spent on all of the routine items, particularly on operation and maintenance. Overall in 2003, routine spending diverged from planned by more than 10 percent, while development spending diverged by more than 40 percent. Low realization of expenditure may be indicative local government's low absorptive capacity. As the need for investments and development programs in Aceh is rising, it is important to ensure that local governments increase their absorptive capacity, particularly with regards to the development spending.

Table 4.5. Planned vs. Actual spending

	2002				2003			
	Planned	Realized	%difference		Planned	Realized	%difference	
Personnel	1,570	1,160	(35.4)		871	797	(9.23)	
Goods & services	162	137	(17.7)		98	85	(15.09)	
Operation & maintenance	50	36	(39.0)		22	18	(25.42)	
Official travel	21	20	(9.1)		15	13	(19.24)	
Other	306	128	(139.5)		-	-	-	
Total Routine	2,109	1,480	(42.4)		1,006	913	(10.23)	
Total Development	1,154	1,088	(6.1)		1,264	883	(43.26)	

Source: World Bank staff calculation based on data from SIKD/MOF.

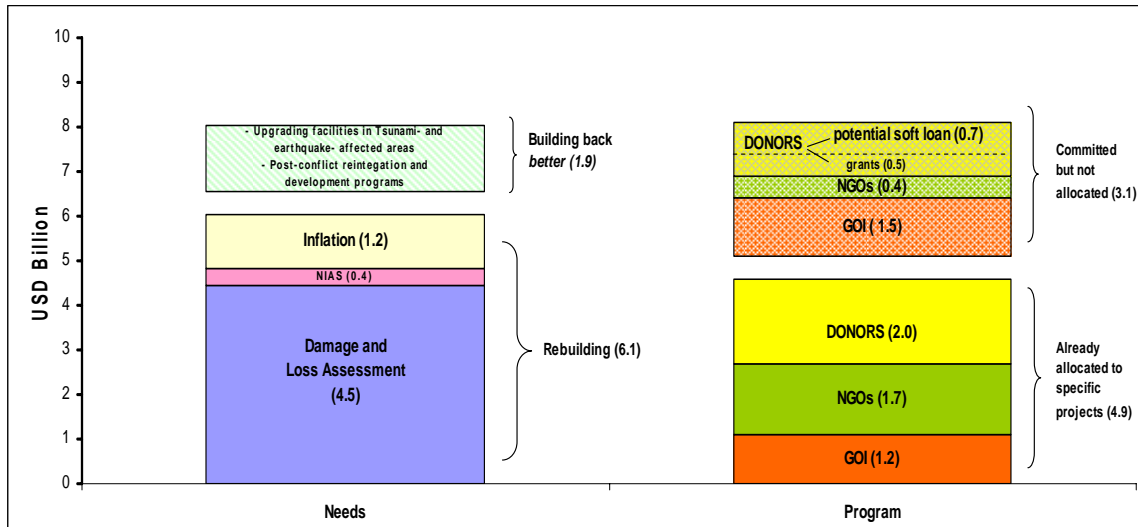
Note: Local government data is based on non-random sample of seven local government in Aceh.

Expenditure on the reconstruction program

Overall financing picture

Expenditures on post-tsunami reconstruction represent substantial amounts of money. By April 2006, US\$ 4.9 billion worth of projects and programs had been allocated to the reconstruction effort. This is more than half of the anticipated total reconstruction program but not yet enough to fully meet the existing reconstruction needs. However, rising inflation will increase the costs of the reconstruction program by an estimated 40 percent, or US\$ 1.2 billion. The discrepancy between US\$ 8 billion of total pledges for reconstruction and development, and US\$ 6.1 in costs, leaves additional resources of about US\$1.9 billion that could be used to invest in long-term development programs (Figure 4.6).

Figure 4.6: Reconstruction needs vs. already allocated and committed resources

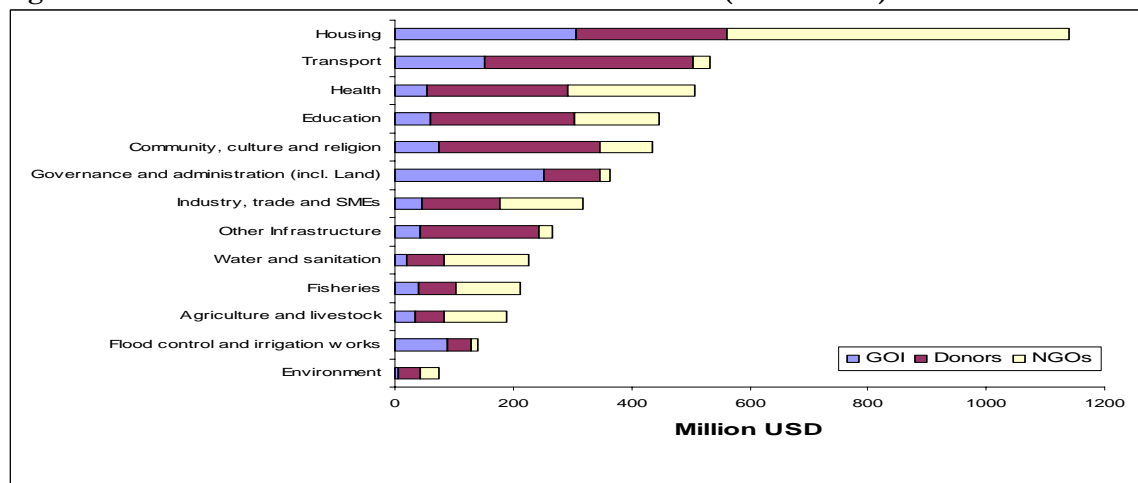


Source: BRR/World Bank staff estimates

Sectoral trends and gaps

Infrastructure and social sectors have received the highest allocations. These two clusters command a combined US\$3.7 billion – or 75 percent – of the existing US\$ 4.9 billion reconstruction portfolio. Housing is the leading sector with US\$1.1 billion, followed by transport, health sector, education, and community infrastructure (Figure 4.7). Housing has become the main focus of BRR and NGOs, followed by sectors such as local government development (BRR) and health and livelihoods (NGOs). As for donors, the focus is on education and transport. Since June 2005, allocations to specific projects have increased by some 54 percent, from US\$ 3 billion to US\$ 4.9 billion in June 2006, and each sector cluster increased in a similar range.

Figure 4.7: Sectoral Distribution of Reconstruction Funds (US\$ million)

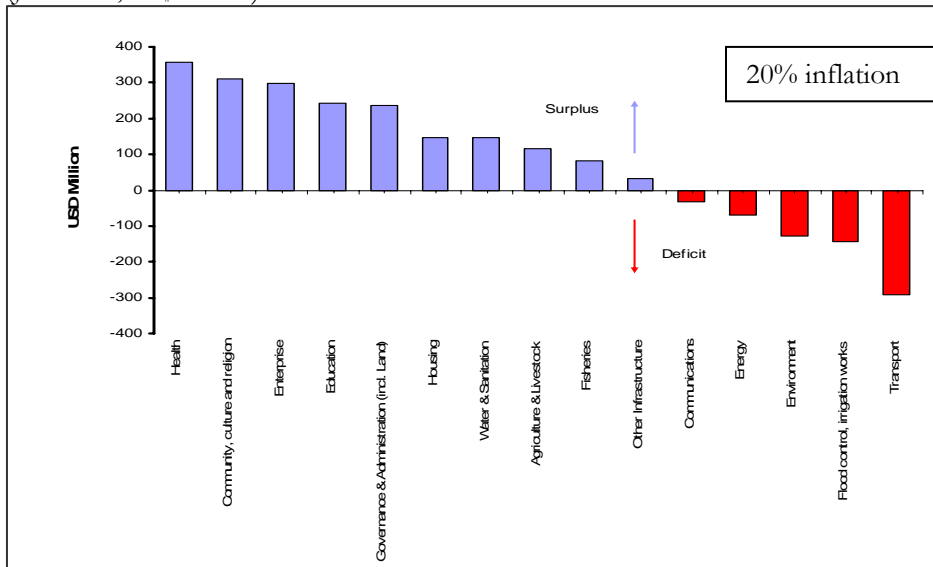


Source: World Bank staff estimates.

Critical financing gaps remain across sectors and regions. Though sufficient funds have been pledged to support the rehabilitation and reconstruction, the current allocation of funds will not meet even the minimum needs in some sectors and many geographic areas. The most critical sectors are particularly transport sector with its large insufficient funding and housing sector with its inflation

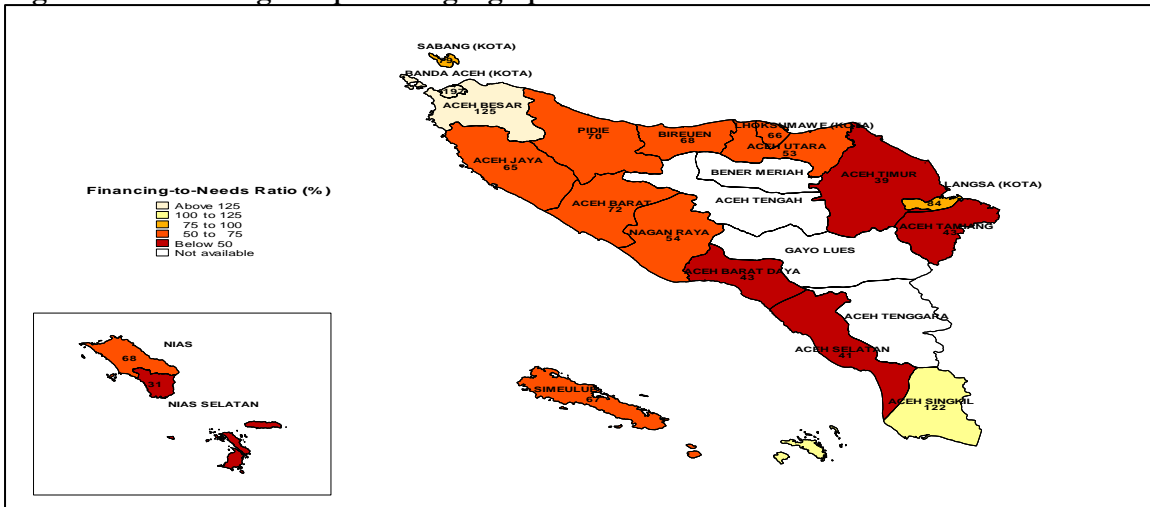
threat (Figure 4.8). On the regional gap, areas around Banda Aceh and Aceh Besar have more than adequate resources to rebuild, while other areas such as a large part of the West Coast, South of Meulaboh, and the North-East Coast of Aceh (Kab. Aceh Timur and Aceh Tamiang), still have inadequate resources (Figure 4.9).

Figure 4.8: Allocation of funds compared to core minimum needs, by sector
(June 2006, US\$ million)



Source: BRR/World Bank staff

Figure 4.9: Financing compared to geographic needs



Source: BRR concept note and World Bank staff calculation

Note: Aceh Singkil's needs are likely to be higher because of damage and losses after March 28 earthquake.

Disbursements

Disbursements have been rising substantially since September 2005, and in June 2006 stood at about US\$ 1.5 billion. This is a sharp increase from September 2005 when total disbursements were around US\$ 400 million. By end-February 2006 disbursements increased to US\$ 976 million and kept pace since then. The disbursement rates of key players vary significantly, by end-June 2006:

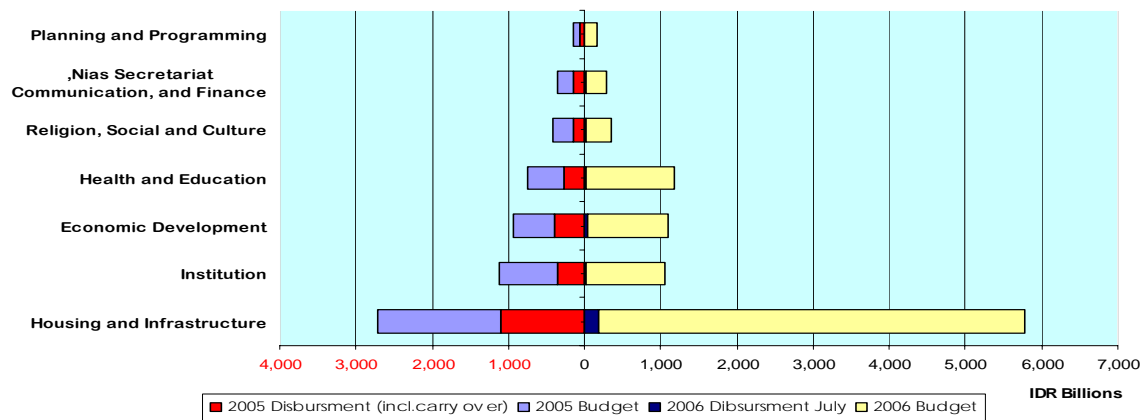
NGOs have disbursed 46 percent of their commitments, donors 22 percent, and the BRR 29 percent.

For the whole reconstruction period (2005-2009), the average disbursements rate will be about US\$ 1.8 billion per year (or US\$ 150 million per month), assuming the total program is at US\$ 8.0 billion. Since October 2005, disbursements have exceeded on average \$100 million per month. By February-2006 almost US\$ 1 billion had already been spent. If the current momentum for disbursements at US\$ 150 million per month continues through the end of the year, an additional US\$1.8 billion would be spent in 2006. In this scenario, about US\$ 3 billion of US\$ 8 billion will be implemented by the end of 2006 which is well below half, and the reconstruction effort will only peak in 2007.

BRR budget portfolio

The 2006 BRR budget has increased by 50 percent compared to the 2005 budget. Among the sectors, infrastructure has experienced the largest increase in allocations. The infrastructure sector (including housing) with Rp. 4.6 trillion available from the 2005 carry-over and 2006 budget will be the focus of 2006 project implementation (Figure 4.10).

Figure 4.10: BRR 2005 and 2006 budgets and spending



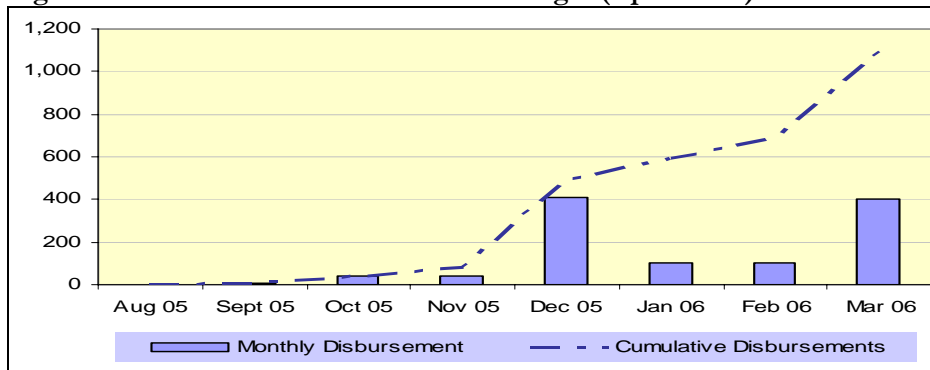
Source: BRR

BRR is the dominant reconstruction player. It has about twice as large portfolio as the next major player (Red Cross). The total government commitment including BRR for the five years rehabilitation and reconstruction program in Aceh is around US\$ 2.4 billion. The budget of about US\$ 800 million for 2007 provides BRR with an opportunity to expand its position in reconstruction financing. BRR will be left with just US\$ 500 million to spend in 2008-2009.

BRR disbursement trends

By end-June 2006, BRR had spent Rp. 2.7 trillion (Figure 4.11). Spending has been equivalent to 29 percent of the total 2005 and 2006 budget allocated. As of June 2006, BRR had an unspent balance of Rp. 1.5 trillion from the 2005 budget and had only spent 4 percent from the 2006 budget. Disbursement patterns seem to suggest that BRR might not be able to disburse its complete budget in 2006. A combination of increased investments in BRR's programming and oversight capacity as well as more flexibility in carrying over unspent budget might be needed given the special circumstances and vast scope of work being undertaken by this agency.

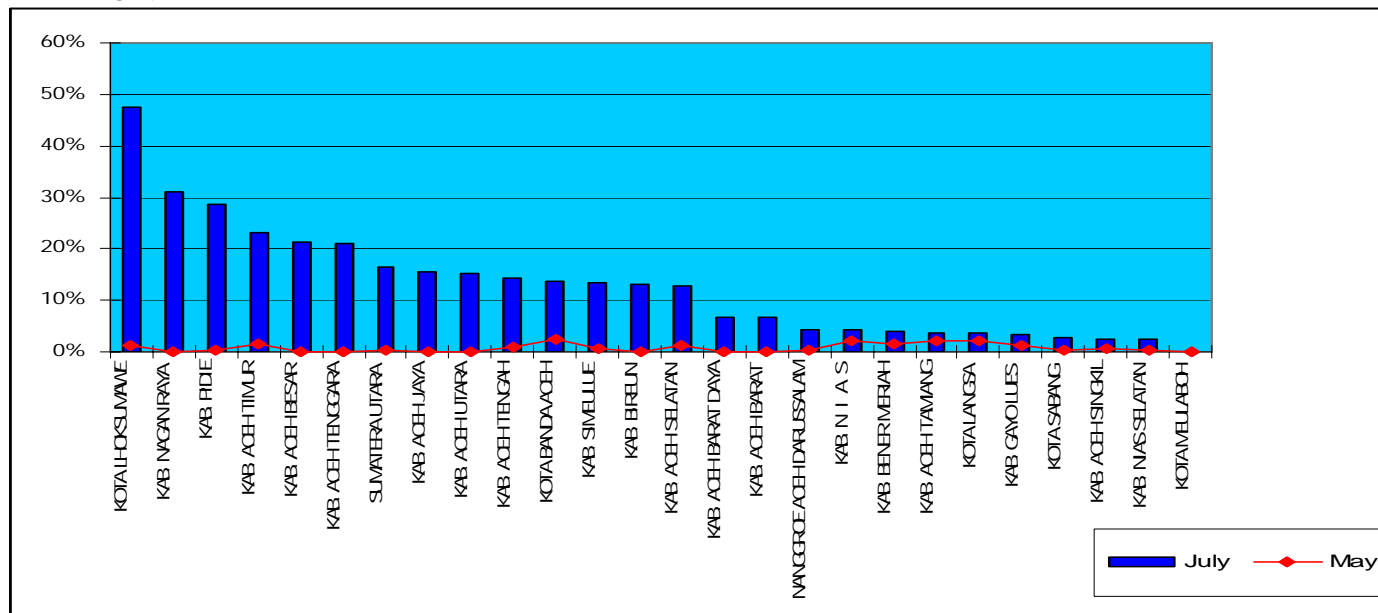
Figure 4.11: Disbursement of BRR 2005 Budget (Rp. Billion)



Source: BRR.

Disbursements are uneven across sectors and even more so across local government. Excluding regular spending on the BRR secretariat, all other sectors have spent less than 10 percent of their portfolio in the 2006 budget. Regarding regions, Lhokseumawe and Nagan Raya have disbursement rates of 30 percent or higher while Meulaboh, Aceh Singkil, and Sabang have the lowest disbursement rate (Figure 4.12), all below 5 percent.

Figure 4.12: BRR disbursement by district (local government), % of total allocation (BRR 2006 Budget)



Source: BRR.

The relatively low levels disbursements of BRR projects are due to a combination of structural and specific problems. Unclear reporting, responsibility, and accountability line; lack of staff and incentives; complexity in procurement procedures, and rising living and operational costs which were not captured in the 2005 DIPA, are some of the structural problems that have been observed. Complexity and insufficient preparation and supervision of projects and lack of training for project managers are some of the specific problems that would need to be addressed in the future.

Recommendations

Now it is a great opportunity for Aceh to “build back better” after the devastating tsunami and long-stand conflict. Large amount of reconstruction funds, coupled with large amount of APBD allow Aceh to address structural poverty problems and boost the region’s economic development and improve quality of public services provision. However, the accountability and transparency of regional government needs to be enhanced to ensure that the public resources are managed and spent effectively.

Now is the time to make strategic (re-)allocation decisions with respect to the reconstruction funds. This is because by end-2006, more than US\$ 6 billion (or about 75 percent of total funds) are expected to be allocated. At this still rather early stage of the reconstruction, the main sources of large scale programmable funds are limited. Despite a large amount of resources available, only few players still have significant amounts of “programmable” funds.

The remaining financing gaps need to be urgently addressed. Though sufficient funds have been pledged overall to support the rehabilitation and reconstruction, the current allocation of funds already programmed by the Government and the donors will not meet even the minimum needs in some critical areas, particularly transport. Several regions also remain severely under-funded, particularly Aceh Barat Daya, Aceh Selatan, Aceh Timur, Aceh Tamiang and Nias.

Future spending by the central government on largely decentralized functions should not be encouraged since regional governments have better understanding of regional priorities and since that would help avoid overlapping and inefficiency in budget allocation. Central government spending can be well targeted through earmarked grant (DAK) with the focus on lagging regions and activities related to national priorities and having large economies of scale.

A tendency toward increased outlays on overall routine expenditure and on government apparatus development expenditure has to be scrutinized. This is especially so given that there are indications that increased spending on government apparatus has not yet 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.

5. SECTORAL ANALYSIS

Health

Health System and Health Outcomes

Health care facilities are generally available but a large number are not functioning due to lack of maintenance. According to *Podes* (BPS Village Potential Survey) there were 37 hospitals, 74 birth clinics, 150 polyclinics, 277 *puskesmas* (health centers), 705 *pustu* (sub health centers), 427 private doctor practices, 1,078 private midwife practices, 4,247 *posyandu* (health post), and 2,765 *polindes* (public midwife practice) in 2005⁶⁹. Not all health facilities are functioning, for example in Kab. Bireuen only 19 percent of the *polindes* are in good or reasonable condition. Services cannot be provided at the remaining 81 percent, which are not functional due to lack of maintenance aggravated by the conflict and tsunami (see picture)⁷⁰. In the absence of on-site health providers, mobile health units should improve village access to formal curative care. Over the last few years the number of such units increased. However, while in theory mobile units increase access to health care, in reality many villages are not served by the *puskesmas keliling*, and if served they provide services at irregular days and often do not have a doctor and/or adequate equipment.



Unequal distribution of facilities indicates different health care needs among districts. Most hospitals (20 out of 37) are clustered in the four city districts (Banda Aceh, Lhokseumawe, Langsa, and Sabang) whilst five districts remain without a hospital. According to the Health and Nutrition Survey (Unicef) about 25 percent of villages in Aceh Province do not have on-site health facilities. Most villages are within 10 km reach of *puskesmas* services, however in Kab. Gayo Lues, Kab. Aceh Jaya, and Kab. Bener Meriah distance to *puskesmas* facilities is farther. In Kab. Aceh Jaya villagers have to travel an average 26 km to *puskesmas* facilities. Mother and child care can be received at the *posyandu*⁷¹, but only 20 percent of the villages have a *posyandu* within an hour walk (5 km). People in Aceh Tengah, Aceh Barat and Aceh Jaya would have to walk on average over 20 km to reach a

⁶⁹ There is inconsistency in the data from the different government institutions. Data from the district health bureaus is often different from the provincial health bureau. Data is often not verified at higher levels of government and there is no set mechanism of data collection. The numbers from *Podes* are slightly lower than government data *pustu* that are most likely overestimated also due to problems of data transfer between *kabupaten* and province. In Bireuen there were 233 *polindes* according to the *dinas kabupaten*, whereas the data of the province suggests that there were 326 *polindes* in the same year. These inconsistencies prevent identifying and addressing needs in the health sector in an efficient manner.

⁷⁰ Health Bureau District Bireuen, 2004. Bireuen may not be an exception, staff from health bureau Aceh Utara, Lhokseumawe, and Pidie claim to have similar levels of facility conditions.

⁷¹ This is a simple health facility set up in the 1970s to get a larger reach for immunizations. Many *posyandus* are not working anymore.

posyandu⁷². Only 49 percent of villages have a village-based midwife or a doctor (6 percent). This finding is in line with the percentage of villages with a puskesmas (4.6 percent) (Podes 2005). Nationally 30 percent of villages do not have a village-based midwife, and thus coverage in Aceh is much lower than national average.

Human resources are far from sufficient to cover all health facilities. The overwhelming majority of health facilities are *pustu* and *polindes* facilities. Although they require only one or two health workers per facility the total number of *polindes* and *pustu* are not all manned. 77 percent of all midwives in Aceh are posted at the *puskesmas* or *polindes* level, but they are not enough to occupy the approximately 3,000 facilities in Aceh province. Similarly 2004 health bureau data show that 214 of the general physicians served at the 258 *puskesmas* facilities. Absence of health workers further reduces service delivery. Low quality of facilities, the unavailability of water, and low living standards provide few incentives for health workers to stay at their assigned posts and the conflict has increased the number of providers moving to urban areas.

Public health services are used more by the poor, whereas the rich more often opt for ‘top end’ private health care providers. 92 percent of the outpatient visits made by people of the lowest income quintile are to public facilities. The table below shows the different use of health facilities according to income levels (Table 5.1).

Table 5.1.: Health care utilization practices across income groups (%)

Income quintile	Share public visits	Public hospital	Private hospital	Doctor	<i>Puskesmas</i> / <i>pustu</i>	Traditional Healer	Other (including polyclinic and nurse)
Poorest	92	10	0	6	70	5	9
2	89	6	0	8	73	3	9
3	80	10	1	10	63	1	16
4	82	8	2	12	65	2	11
Richest	69	15	2	22	47	1	12

Source: SUSENAS 2004.

Despite these shortcomings, life expectancy in Aceh is better than national average. In Aceh, life expectancy in 2003 was 67.7 years compared to 66.2 years national average⁷³ (UNDP, 2002), a tenth of a year increase in comparison to 1999 life expectancy. Only 12.2 percent of Acehnese are not expected to live beyond 40 years, compared to 15 percent in Indonesia overall.

Health care policies

Reducing fees for services has not addressed the issue of ‘under utilization’ of public services. The health card, replaced by JPK Gakin (health insurance) in 2005, the regulation of Aceh’s governor, and JPK-MM are all intended to decrease costs. The JPK-Gakin enables poor households to access third class health care services without paying a service fee. Low dissemination of the program’s benefits has reduced its impact. The generally perceived poor quality of public health services and irregular opening hours discourage people from seeking medical attention. The impact of highly subsidized low *puskesmas* fees on service utilization is thus minimal. Fees for hospital services are more significant and the policies do not take into account the relatively high indirect

⁷² Podes 2005

⁷³ National average is from 2002

costs (transportation costs, meal costs, etc.) of hospitalization incurred by patients, resulting in many poor households deciding against referral to the hospital.

The Aceh Governor's regulation entitles all Acehnese to free *puskesmas* services. However, no additional funding has been provided to *puskesmas* to compensate for the lost income. Before 2002, *puskesmas* were allowed to keep 20 percent of the collected service fees. Even then the retained funds were not enough to cover the full *puskesmas* costs as *puskesmas* fees were only Rp. 1,500 per consultation. As the provision of services has become free, *puskesmas* face increasing difficulties in paying their operational expenses.

The central government has recently introduced the JPK-MM direct block grants to "increase access (for the poor) and quality of health care services by reducing out-of-pocket health care costs".⁷⁴ Since July 2005 the central government has provided subsidies directly in the form of block grants to *puskesmas*. The JPK-MM block grant is earmarked for 4 *Puskesmas* activities: Basic Health Services, Delivery Service Packet, Management and Operational Resources, and Nutrition Rehabilitation and Revitalization. *Puskesmas* that participate in the program must sign a Letter of Agreement on the Provision of Aid agreeing to use resources according to strict guidelines.

Disbursement delays of the block grants have affected service delivery. *Puskesmas* report major delays in the disbursement of the JPK-MM block grant. Not all *puskesmas* can pre-pay the services and, as a result, interruption in the provision of services has been reported. Once funds have finally arrived in *puskesmas* accounts the funds remain unspent since rules are not clear about the reimbursement of *puskesmas* expenses. Other entitlements such as the free provision of midwifery services are already paid by the patients and can thus not easily be returned. *Puskesmas* heads do not have the authority to reallocate funds and thus they remain unspent until further news from the district health bureau.

Impact of the conflict and tsunami on the health system and health outcomes

During the conflict, although health facilities were not purposely targeted, as were schools, health infrastructure was seriously damaged. During the first week of the implementation of martial law in 2003, three sub health centers and 35 village maternity clinics were burned down in Kab. Birueun and Kab. Pidie, adding to the 8 health centers, 19 health sub-centers, and 7 mobile units destroyed in the province during previous years of hostilities⁷⁵. In addition, 20 health care staff lost their lives between 1999 and 2004, and another 29 health care staff from 20 districts were subject to violence. As a result of the conflict many midwives left their posts to live in the city. Without operational funds the services provided by them have halted.

The conflict contributed to overburden in the health care system due to the large number of displaced people, restricted access to services in conflict areas, and increased the need for specialized care. In addition, during the conflict many health workers moved from rural to urban areas resulting in sparse provision of health care services in rural areas⁷⁶. In some villages services have discontinued whereas in others services are at irregular hours depending on the provider. Villagers often depend on traditional providers for health care advice or a provider at a more distant location. Even though the conflict has ended these providers have not returned to their postings.

⁷⁴ Manlak Depkes, 2005.

⁷⁵ Source: Conversations with staff at *Bagian Pelayanan Kesehatan Rujukan*.

⁷⁶ Nurses and midwives from villages in kecamatan Kaway XVI, Aceh Barat, moved to the city during the conflict

The tsunami caused widespread damage to health facilities and human resources. The earthquake and tsunami of 26th of December caused significant destruction in the health sector, damaging or destroying 8 hospitals, 41 *puskesmas*, 59 *pustu*, 44 *posyandu*, and 240 *polindes*. The provincial health bureau was also heavily damaged, with a heavy loss of information and data. A large number of health professionals lost their lives: 17 doctors, 3 dentists, 49 midwives, 30 nurses, 2 pharmacists, and 104 support staff. According to the provincial health office, another 489 health staff were still missing as of April 2005. At the same time, about 1,306 new health staff has been recruited including 222 medical doctors and 162 midwives to replace perished staff.

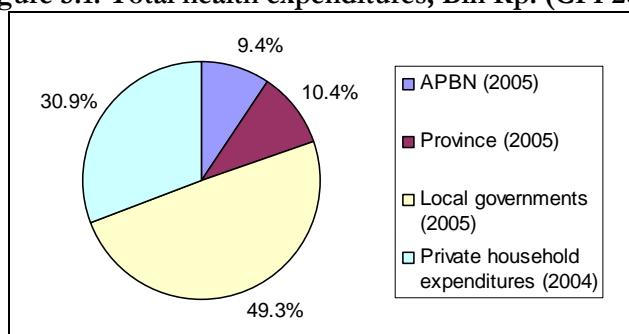
The tsunami left more than 500,000 people homeless, most forced to move to IDP camps, which created specific health care issues. Over 50,000 people still remained in the IDP camps as of April 2005. The IDP camps have to deal with specific health issues related to the limited access to water and poor sanitation. Despite the perceived larger threats to health nutrition indicators, a recent study by UNICEF did not identify significant differences in wasting, global acute malnutrition, stunting, underweight, and anemia between children living in IDP camps and non-IDPs.⁷⁷

Recovery is ongoing, but takes longer than initially expected. 30 percent of the damaged health infrastructure had been rebuilt by April 2005.⁷⁸ 8 major hospital reconstructions and rehabilitation projects had been completed and another 13 were ongoing. Half of the damaged *puskesmas* and *pustu* was under reconstruction as of April 2006.

Spending on health vs. quality of health care and health outcomes

In 2005, total expenditures on health were almost Rp. 700 billion, the majority contributed by the province and districts. Health expenditures are largely decentralized; 58 percent of health expenditures are spent by the province and districts. Household private, out-of-pocket spending on health is almost one third at over Rp. 200 billion⁷⁹. Central government spending through APBN contributes only 9 percent of expenditures. (Figure 5.2).

Figure 5.1: Total health expenditures, Bln Rp. (CPI 2005)



Source: database, BRR database, and SUSENAS 2004.

A larger percentage of the poorer households had health care expenditures than the richer households. However, the wealthier households spent more in real terms. An Acehnese spends on average Rp. 5,993 per month on health (SUSENAS 2004) (Table 5.2). Relative to their income, these expenses will have a larger impact on poorer households' disposable income. In comparison to other provinces in Indonesia, Acehnese households spend very little on health care,

⁷⁷ UNICEF, 2005.

⁷⁸ BRR.

⁷⁹ Household expenditure data from SUSENAS 2004 is used to approximate 2005 expenses.

but SUSENAS data on regional utilization of health care services show that this is not due to a lower utilization rate by the Acehnese.

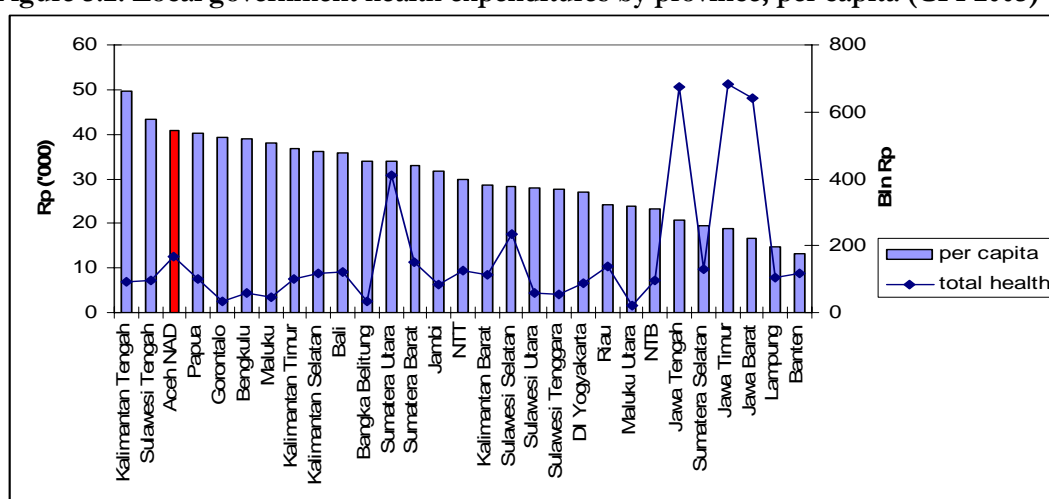
Table 5.2: Household monthly health expenses across income quintiles (%)

	Poorest	2	3	4	Richest	Average
Share of households making any health expenses	69	58	55	60	50	58
Household health expenses (Rp)	3,907	5,673	9,449	6,871	12,903	5,993

Source: SUSENAS 2004.⁸⁰

Per capita district health spending in Aceh is higher than the Indonesian average. Ranking third highest of 29 provinces in Indonesia, local government health expenditure in Aceh is about 40.800 Rp. per capita. Despite relatively high health spending health provision indicators give a bleak picture.

Figure 5.2: Local government health expenditures by province, per capita (CPI 2005)

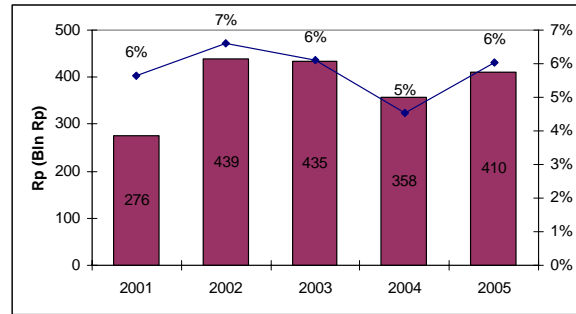


Source: World Bank Staff, data for DKI Jakarta is not available.

In absolute terms, regional health expenditures increased after decentralization but the share in total regional expenses did not change much (Figure 5.3). As a result of the special autonomy status, absolute health expenditures increased by about 50 percent, but the share of total expenditures allocated to health stayed between 5 and 7 percent.

⁸⁰ Households that made no expenses were excluded to calculate average household health expenses.

Figure 5.3: Total health expenditures and health expenditures as a share of total regional expenditures.



Source: World Bank staff estimates based on data from MOF.

District governments spend more on health than the provincial and central government. The share of province expenditures decreased after decentralization when local government health expenditures rose; in 2005 only 15 percent of total health expenses are contributed by the province, versus 71 percent from districts and 14 percent from the centre. A similar breakdown applies to contributions to routine and development expenditures (Table 5.3).

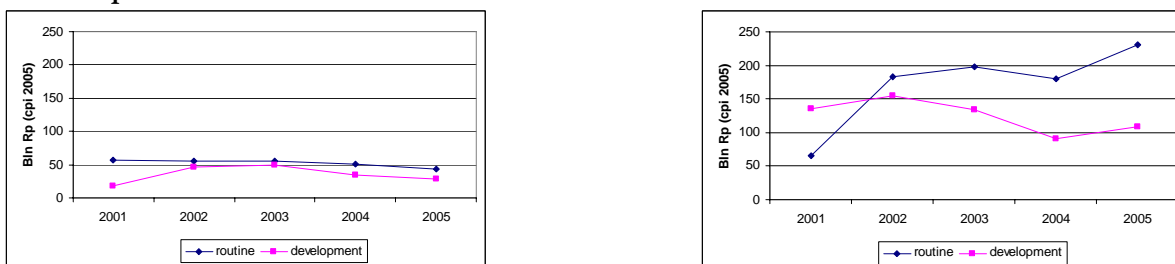
Table 5.3: 2005 Central, Provincial, and District health expenditures

	Central		Province		District		Total	
	Bln Rp	%	Bln Rp	%	Bln Rp	%	Bln Rp	%
Total	65	13.6	71	15.0	338	71.3	474	100
Development	18	11.9	28	18.0	108	70.2	155	100
Routine	46	14.5	43	13.6	230	71.9	320	100

Source: World Bank staff calculations

Routine expenditure is increasing whereas development expenditure is decreasing; leading to an increased share of routine spending on health. Since decentralization regional routine expenditures more than doubled from Rp. 123 to 273 billion, mostly due to an increase in district routine spending. Development expenditure has decreased; 2001 development spending was Rp. 17 Bln higher than 2005 development health spending (Figure). As a result of both trends the share of routine expenditures increased from 45 percent in 2001 to 67 percent in 2005. Across districts there are wide variations in routine vs. development spending; Kab. Langsa has relatively high routine expenditures (up to 79 percent of total district health spending), whereas Kab. Aceh Barat Daya spent relatively high shares on development (44 percent)⁸¹.

Figure 5.4: District (right) and provincial (left) government development and routine expenditures



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

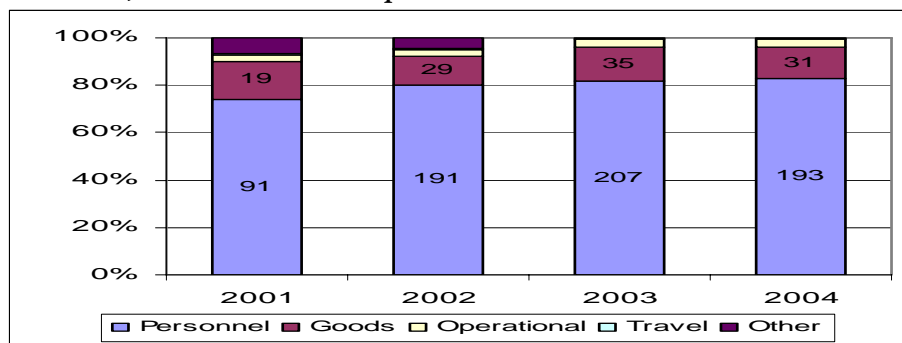
⁸¹ World Bank staff estimates, MoF dataset

The use of health resources

Majority of routine expenditures is spent on health provider wages. An increasing share of total health expenditures is taken up by salaries; in 2001 33 percent of total expenditures were attributed to wages or 74 percent of routine expenditures. In 2004, wages as a share of total expenditures was 54 percent and 83 percent as a share of routine expenditures (Figure 5.5).

Operational costs are too small to guarantee quality services. In 2004, only 0.8 million (2 percent of total health expenditures) was spent on operational costs. *Puskesmas* facilities receive a small allocation for operational expenses, which is always below the requested budget allocation. As a result there are not enough resources to operate the *puskesmas* fully. For example, due to lack of budget the *puskesmas keliling* (mobile unit) often does not operate. When the *pusing* has to serve as an ambulance patients have to pay, a price approximately twice as high as the local transport (*angkot*).

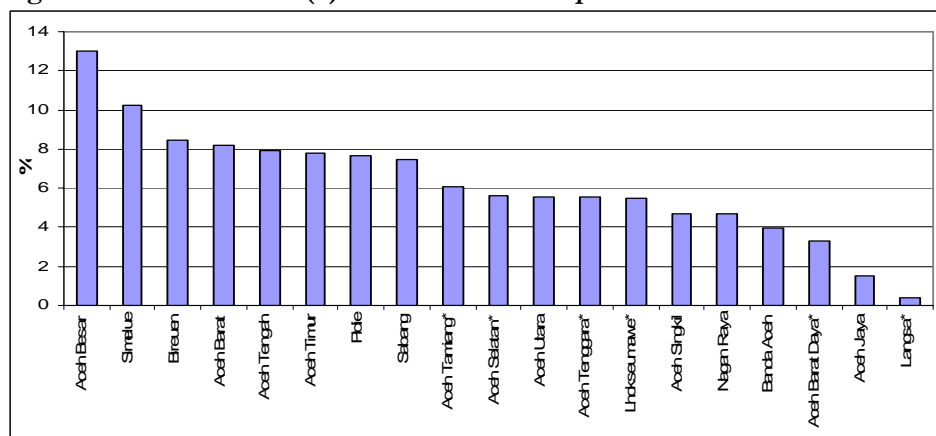
Figure 5.5: Total routine health expenditures broken down in personnel or salaries, goods, and others, in shares and Bln Rp.



Source: World Bank staff estimates based on data from MOF.

The majority of districts in Aceh spend a lower share of total spending on health than national average (7.2 percent). District health expenditures are between 1.5 percent and 13.0 percent of total expenditures. Capacity could be an issue, staff of the district health bureau of Kab. Aceh Utara, the richest district of the province, claim that more funds for health care services are available but they are reluctant to request more funds as the capacity to spend the resources is lacking.

Figure 5.6: District 2004 (*) and 2005 health expenditures as a share of total expenditures.



Source: World Bank staff calculations based on data from MOF.

Recommendations

Public health expenditures are relatively low in Aceh. Relative to Indonesia district spending on health (which contributes 71 percent of health expenditures) is relatively low and private contributions from households make up a large share of total health expenditures. Unpredictable health expenditures can easily drive people in poverty especially when the number of households living below and around the poverty line is as high as in Aceh. Therefore, increased spending on health across the board would benefit the people in Aceh.

There is an urgent need to rebuild the data management information system to support prioritization of the health budget allocation. The governmental health institutions are overwhelmed with data, which seem to be collected without a clear purpose. As a result there is little attention to the quality of the data and comparison of different data sources within the health bureau shows inconsistencies. As a result of the conflict and the tsunami much data has been lost. A proper stocktaking of health infrastructure, human resources, and services is therefore very difficult. The lack of an institutionalized flow of data between districts and province hampers the quality of data further. Proper verification of data is not possible and it has not received the attention it deserves.

There is strong focus on improving and building facilities, enhanced by the increasing number of districts, but construction should be linked to a needs assessment and an efficient use of resources. Proper mapping of health care facilities, its maintenance, and human resources is important before deciding to build more health care services. Since decentralization the number of *puskesmas* and *pustu* has kept increasing, however, as the data suggest, human resources are not sufficient to actually staff the new facilities. As a result facilities are minimally equipped and the working environment does not support health care staff, who consequently are not willing to stay at the facility but prefer to leave their posting. Communities do not want or benefit from just a building, they also need health care providers; distance would not be an issue if people were provided with appropriate health care services.

The mobility of health care providers should be facilitated to increase the effectiveness of health care services. At the village level providers depend on their own transportation. Provision of transport for health care staff, especially midwives in the field, is essential to increase utilization of their services. Without the support of the *puskesmas* provision of antenatal care, assistance during birth, postnatal care, immunizations, and socialization of best information and best practice depend on the midwife.

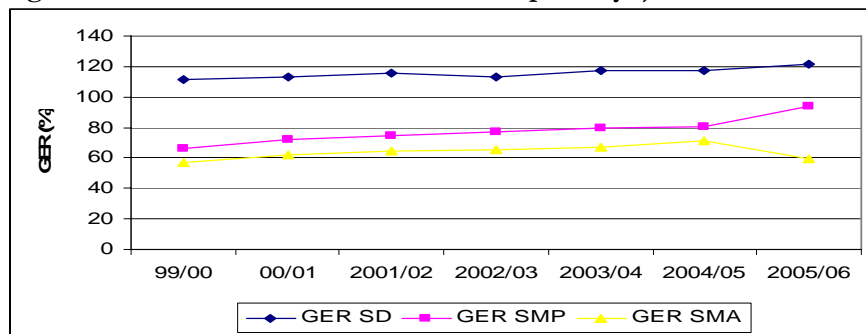
Central government spending on health should be on centralized tasks only. The central government subsidies (block grants) to *puskesmas* cover a responsibility of the district government, as operational costs of a *puskesmas* should be covered by the district government. Since the operational costs covered by the block grant are not sufficient for total operational costs, district governments have to provide the additional funding. The allocation of central government spending in the regions is very unpredictable and to operate district governments cannot dependent on this revenue that is subject to changing regulations. Noteworthy, there are already indications that districts seem to adapt their expenditures accordingly.

Education

Education system and education outcomes

Provincial education bureau data suggest that over the past 5 years enrollment rates in Aceh have steadily increased. Between 2000 and 2004 elementary school (SD) gross enrollment rate increased slightly from 111 to 118 percent; junior high school (SMP) gross enrollment rate increased from 67 to 80 percent; and senior high school (SMA) gross enrollment rates from 57 to 72 percent (Figure 5.7). Comparison to national gross enrollment rates over time shows that Aceh has relatively high enrollment rates; in 2004 GER for primary, junior secondary, and senior secondary were 107 percent, 82 percent, and 54 percent⁸².

Figure 5.7: Gross enrollment rate trend for primary, junior, and senior high school in Aceh



Source: Ministry of National Education and BPS population data, various years.

Trends in enrollment rates are more reliable than enrollment levels, which seem overestimated. Review of the education bureau data and BPS population data is necessary to make a reliable estimate of enrollment rates. Five different sources (BPS, Education Bureau, and SUSENAS) on 2004/2005 SD student enrollment numbers (both private and public) vary from 523,228 to 579,804 students, the religion bureau data does not seem to vary significantly, creating GERs ranging from 118 percent to 127 percent⁸³. Other data issues include a mismatch between the number of SD students graduated in 2004/2005 with the number of SD students enrolled in the final grade of that year.

Net and gross primary school enrollment rates suggest proper access to primary schools but large district variations remain; Kab. Aceh Jaya seems to perform well below average. *Podes* 2005 suggests there were 1,033 pre-schools and 3,560 primary schools in Aceh province, thus 54 percent of the 3,117 villages in Aceh do not have a primary school⁸⁴. Compared to the national average, net enrollment rates in primary education in Aceh are slightly higher, 93 percent in 2004; only 4 districts fall below the national average, Kab. Aceh Barat Daya, Kab. Nagan Raya, Kab. Aceh Barat, and Kab. Aceh Jaya (Figure 5.8). A GER exceeding 90 percent for a particular level of

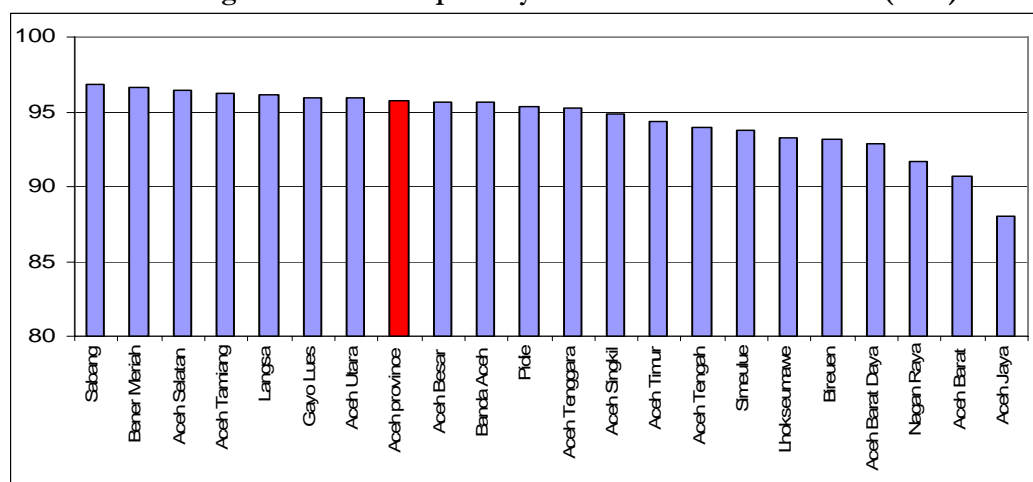
⁸² Draft Indonesia public expenditure analysis of the education sector, 2006.

⁸³ “Rangkuman Data Pendidikan” and “Data Kebutuhan Guru” Dinas Pendidikan Propinsi, Aceh Dalam Angka, and Ministry of National Education

⁸⁴ The number of pre-schools or TK is slightly higher than provincial education bureau data (856), possibly because not all TKs are recognized by the provincial education bureau. The data on primary schools is lower than the provincial data (3810) most likely to be more reliable than provincial data.

education suggests that the aggregate number of places for students approaches the number required for universal access of the official age-group⁸⁵.

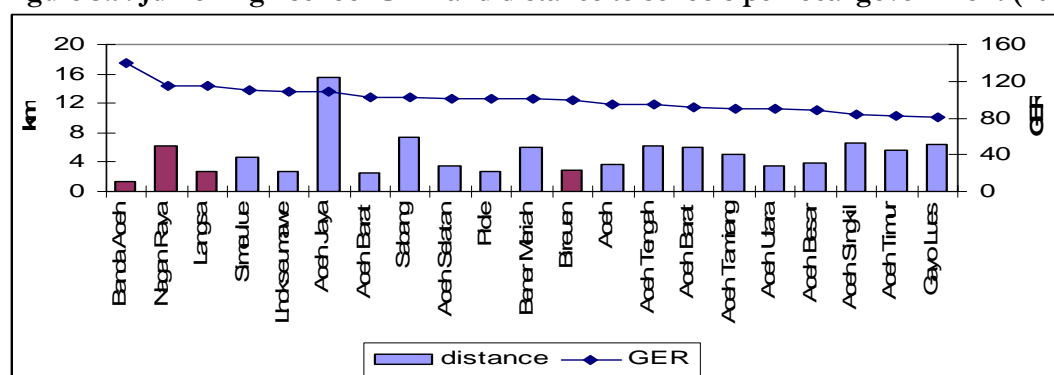
Figure 5.8: District primary school net enrollment rates (2005)



Source: BPS Aceh census 2005

Secondary education enrollment is much lower than primary education; distance is not the determining factor. Students have the choice between 757 junior and 378 senior high schools.⁸⁶ Based on the number of students from the education bureau and the population data, there is quite some variation in enrollment rates between districts. Banda Aceh is an outlier with GER of 140 percent, possibly due to an influx of students after the tsunami not registered in the city. The other districts vary between 80 and 115 percent GER. The average distance to a junior high school outside the village is 5 km but students have to cover an average of 16 km in Kab. Aceh Jaya. The distance to SMP and SMP GER are not significantly correlated (Figure 5.9).

Figure 5.9: Junior high school GER and distance to schools per local government (2005)



Source: Podes 2005, Provincial Education Bureau, and Census.

The majority of students choose non-religious formal education. Although the Acehnese are considered to be very religious, most students attend non-religious schools; 18 percent of elementary school children and 30 percent of both junior and senior secondary school children go to religious schools⁸⁷. All levels of religious schools (MI, MTs and MA) have the same curriculum as non-

⁸⁵ UNESCO institute for Statistics “Education Indicators”

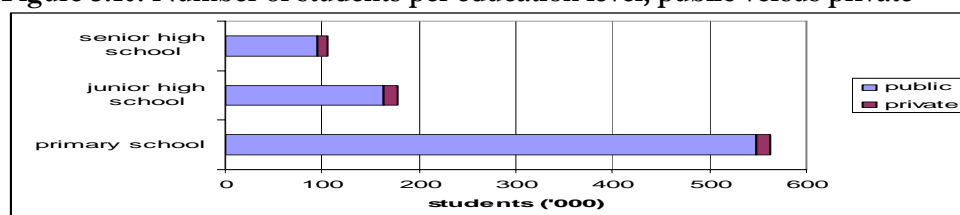
⁸⁶ Podes 2005

⁸⁷ Student data from the Dinas Pendidikan Propinsi NAD (source: central government projections).

religious schools but its students have additional religious courses, attributing to a 30 percent increase in school hours per week.

Public schools are generally preferred because of lower costs, better equipment, and higher quality but some public schools have limited enrollment. Less than 10 percent of the students go to private schools (Figure 5.10). Operational costs for public schools are covered by the government, whereas operational costs for private schools are covered mainly through school fees paid by parents⁸⁸. Public and private schools have the same curriculum, teaching hours, and national test requirements. Private schools are in demand where public schools are not available, where public schools have maximum enrollment levels, and where there are households who can afford expensive, better quality education. SMA Anak Bangsa Banda Aceh and SMA Yapena Lhokseumawe are examples of better quality private education; high fees enable the hiring of quality teachers, the buying of good books, and quality equipment.

Figure 5.10: Number of students per education level, public versus private



Source: Dinas Pendidikan Propinsi 2004/2005

The new education law No. 19/2005⁸⁹ requires teachers to have a bachelor degree but throughout Aceh only 37 percent of teachers fulfill this requirement⁹⁰. At primary school level between 13 percent and 28 percent of the teachers fulfill this requirement. Teachers at religious schools on average have higher degrees than teachers at non-religious schools. Although teachers at religious schools have higher levels of educational attainment (58-75 percent versus 50 percent) provincial education bureau data suggest that student performance on the national tests are similar. Junior high school teachers are more qualified than elementary school teachers. The highest qualifications are found at the senior high school level.

Table 5.4: Teacher qualifications in Aceh province (%)

	SD		MI		SMP		MTs		SMA/MA
	Public	Private	Public	Private	Public	Private	Public	Private	Public + Private
D1	44	50	26	34	13	16	5	13	2
D2	37	26	43	26	9	6	3	4	1
D3	6	8	6	12	32	27	19	26	19
Bachelor degree or higher	13	15	25	28	46	51	73	58	77
Total	100	100	100	100	100	100	100	100	100

Source: Provincial education bureau NAD, 2005/2006

⁸⁸ Private schools sometimes receive government subsidies (such as teachers and books, but also training, and operational costs) but mainly depend on private contributions.

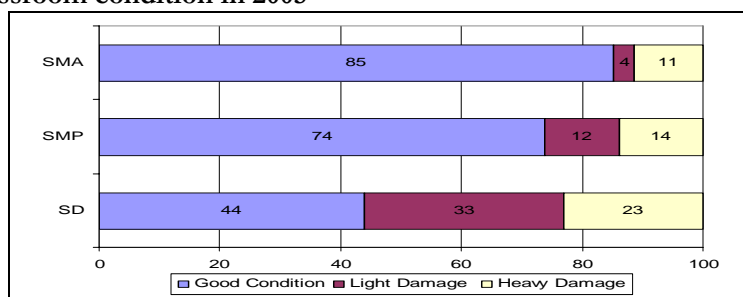
⁸⁹ "Peraturan Pemerintah Republik Indonesia Nomor 19 Tahun 2005 tentang Standar nasional Pendidikan", Jakarta.

⁹⁰ Provincial Education Bureau, NAD

Higher trained teachers are selected for government apparatus positions. According to staff of the Education Bureau 75 percent of teachers who get a bachelor or higher quickly move to positions outside teaching such as working at the education bureau. Although base salaries of teacher positions and government apparatus positions are the same, staff in non-teaching positions have greater opportunity for additional benefits from projects and have more growth opportunities. In the current salary structure there are no incentives for teachers to maintain primary teaching positions and as a result quality of teaching remains low and teacher absenteeism is high. Analysis of the governance and decentralization survey, which covered 72 teachers in Kab. Aceh Utara, Kab. Aceh Besar, and Kab. Aceh Barat suggests that 30 percent of the teachers were absent during school time, engaged in tasks outside school, sick or attending to private business.

Quality of teaching is inhibited further by the poor condition of school buildings. Almost a quarter (23 percent) of elementary classrooms are classified as heavily damaged and require complete reconstruction. Only 44 percent of elementary classrooms in Aceh are considered in good condition, whereas 33 percent has light damage and requires some reconstruction work (Figure 5.11)⁹¹. Although the general condition of higher levels of education is much better more than 1 in 10 classrooms should be completely renovated.

Figure 5.11: Classroom condition in 2005



Source: Provincial Education Bureau NAD, 2005.

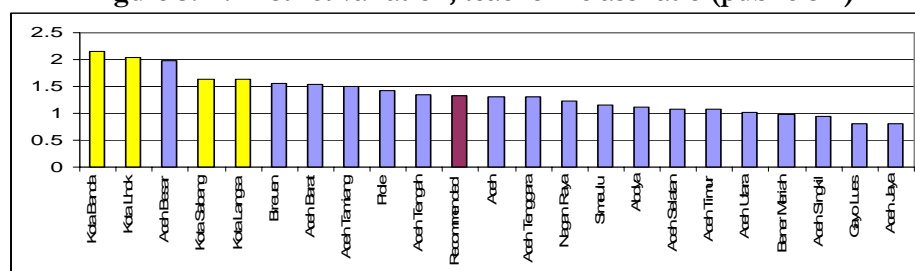
A scarcity of schoolbooks and school facilities negatively impacts education. Although the full extent of lack of schoolbooks in Aceh is not available, a case study of the junior high school (SLTP 1) in Sabang provides a good example. 200 grade 1 students of ‘SLTP 1’ share 40 textbooks. Teachers acknowledge this problem; to ensure that books do not get lost teachers often bring the books home, further limiting their use. The government has acknowledged the need for books and has allocated money for books. Beginning this year central government allocated Rp. 113 billion for primary and junior secondary schoolbooks but this budget was cut to Rp. 20 billion, or 1 book per student. Disbursement of the funds did not come through by the start of the school year. Most schools do not have a library or laboratory facilities; 32 percent of junior high schools and 64 percent of senior high schools have small libraries. While 30 percent and 40 percent of these schools have laboratories⁹².

Teachers favor urban areas, creating unnecessary needs in rural areas. A teacher-class ratio of 1.3 is sufficient to meet minimum service standards. Data per district (Figure 5.12) indicates that there are significantly more teachers in urban than in some rural areas. This problem has been persistent in recent years.

⁹¹ The consensus about the definitions of the condition seems to be that light damage requires maintenance, whereas Damage of facilities is due to a number of factors including the conflict, the tsunami, but the majority due to lack of maintenance. Ministry of National Education, 2005, “Indonesia Educational Statistics in Brief 2004/2004”.

⁹² Provincial Education Bureau NAD, 2005

Figure 5.12: District variation, teacher - class ratio (public SD)



Source: Provincial education bureau, 2005/2006

Minimum service standards do not necessarily reflect regional needs and increases inefficiency of human resource allocation. Teacher need is calculated based on number of teachers per school. According to minimum service standards rules, each elementary school should have a minimum of six class teachers, one sports, and one religion teacher. Based on this rule another 4,654 teachers would be needed for primary schools (SD). The student teacher ratio (STR) for elementary schools in Aceh is already half the targeted STR of 40:1 indicated by the minimum service standards. Allocating additional teachers would only increase the already inefficient use of human resources. A further increase in the number of teachers would only be warranted if the number of students increases significantly. The almost complete primary enrollment rates and declining infant fertility do not foresee such a need in the near future. School regrouping where geography allows it and multilevel teaching in more remote areas would reduce the need for so many teachers.

The impact of the conflict and tsunami on the education system and outcomes

The long-running conflict has inflicted major damage to education infrastructure. Loss of human resources, temporary drop-out of students, and delays in policy implementation are all a major setback for education services. Between August 1998 and August 2001, 369 school buildings were torched, of which 70 percent were primary schools. Even worse was the period of Martial Law (May – June 2003) during which 510 schools, 13 percent of public and private elementary and high schools in 2003⁹³, were burned down (Table 5.5).

Table 5.5: Number of schools destroyed per district August 1998 – June 2003

District	August 1998 - August 2001 Period			Martial Law, 19 May - 18 June 2003 Period			Total
	SD	SMP	SMA and SMK	SD	SMP	SMA and SMK	
Pidie	28	15	6	219	29	4	301
Bireuen	7	1	1	119	11	5	144
North Aceh	66	26	14	3	1	1	111
East Aceh	17	5	4	37	8	7	78
Central Aceh	36	5	1	0	0	0	42
West Aceh	13	9	3	6	2	0	33
Aceh Selatan	65	18	6	0	0	0	89
Other districts	11	8	4	41	14	3	81
Total	243	87	39	425	65	120	979

Source: Bappeda and NAD Department of Education.

⁹³ In 2003 there were 3244 public and private elementary schools, 566 public and private junior high schools, and 256 public and private senior high schools.

Many children displaced to conflict IDP camps quit school, at least temporarily. According to the NAD Department of Education, the number of IDPs reached around 41,000, including 16,352 students (approximately 1 percent of students).⁹⁴ The education process was interrupted, and many students of primary and secondary schools failed to take school final examinations.⁹⁵ Teachers were also victims and many of them moved to urban areas. Similarly, conflict hampered the implementation of new policies to improve the quality of education, such as teaching-learning activities (PBM).

The government showed commitment to provide temporary tents and rebuild damaged schools. In 2003, a Rp. 40 billion (about US\$ 4.4 million) budget was allocated for reconstruction and other humanitarian assistance. Expenditures were adjusted to shift within the already approved 30 percent education fund budget from non-physical expenses to emergency education infrastructure development. The reconstruction of torched schools faced obstacles, as there was little information on the number of classrooms damaged, students and locations of torched schools.

The earthquake and tsunami of December 26, 2004 took the lives of almost 2,500 teachers and tens of thousands of students. More than 2,000 schools were reported as severely damaged or destroyed.⁹⁶ But many schools were already in bad condition due to conflict or lack of maintenance; in Kab. Bireuen only 25 percent of the damage was due to the tsunami or earthquake. Reconstruction is on its way. Teachers have been recruited to replace the casualties, but the majority of damaged schools still need to be rebuilt. By April 2005, 2,430 out of 2,500 perished teachers had been replaced. 260 schools had been rebuilt and another 104 schools are in progress. International donors, NGOs, and the Indonesian government have committed to the reconstruction of another 141 schools⁹⁷. Approximately 1,500 schools will still require rehabilitation after the tsunami pledges have been achieved. However, coordination was lacking in the reconstruction efforts with the result that there is an overlapping of reconstruction in urban areas and large gaps in rural areas.

The tsunami temporarily disturbed the education process, but most children ultimately went back to school. According to the October 2005 population census in Aceh 95 percent of children age 7-12 is attending school, which is not different from the pre-tsunami enrollment levels. Impact of the tsunami on the continuance of education and passing rate of students can only be made after data issues mentioned in the beginning of this chapter have been resolved.

Young children of age 0-4 were disproportionately casualties to the tsunami, which will cause a shift in student distribution. A basic comparison of the population census of 2005 with the population projection of 2005 indicates a 7 percent reduction in the number of children in the age group of 0-4 years, and a 3 percent reduction in the age group of 5-9 years. That means that approximately 40,000 pupils less than initially planned will be going to primary education during the next four years. Comparison of new student enrollment numbers with projections from before the tsunami shows the decline in enrollment; 114,410 new students versus the predicted 126.510⁹⁸. Decreasing class sizes initially for SD and later for SMP thus need to be expected. The generous amount of funds allocated to the education sector after the tsunami can be used for programs to improve the quality of teaching and leave a legacy of better quality education in Aceh.

⁹⁴ Serambi Indonesia, 19 June 2003.

⁹⁵ Serambi Indonesia, 26 May 2003.

⁹⁶ BRR.

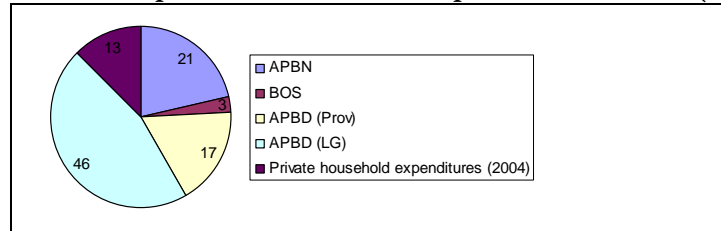
⁹⁷ BRR survey May 2006

⁹⁸ Provincial Education Bureau, 2005.

Spending on Education vs. Quality of Education and Education Outcomes

Education expenditures in Aceh includes those by central government (APBN), regional governments (APBD I + II) and private household expenditures, adding up to 2.8 trillion Rp. in 2005. Local governments are the biggest spender with about Rp. 1.2 trillion or 46 percent of total expenses, followed by Rp. 655 billion of central spending (APBN and BOS contribute to 24 percent of spending)⁹⁹. Private contributions from households should not be neglected contributing 340 billion Rp. to total education spending¹⁰⁰ (Figure 5.13).

Figure 5.13: Composition of education expenditures in Aceh (%) 2005

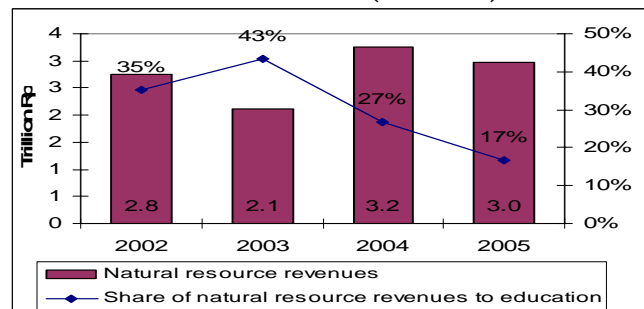


Source: SIKD MoF, BOS MoNE, and SUSENAS 2004. Throughout this document education includes expenses of religious and culture bureaus unless specified otherwise.

Private expenditures contribute significantly to the total education expenditures. Extrapolating adjusted 2004 SUSENAS to 2005 suggests that private contributions to education add another Rp. 340 billion to education spending. Analysis of the Governance and Decentralization Survey data shows that private spending for junior and senior high school goes primarily to books, writing material and transport costs when necessary, whereas enrollment and monthly fees seem to make a smaller share of spending.

The Aceh Special Autonomy Law No. 18/2001 highlights the importance of education and stipulates that a minimum 30 percent of natural resources revenues be allocated for education spending; since 2003 expenditures have been below 30 percent. During the first three years of decentralization well above 30 percent of natural resources revenues were allocated for the education fund, at the same time the share of education expenditures increased from 11 percent in 2001 to 25 percent in 2004 (Figure 5.14). However, allocation from natural resources dropped to 16 percent in 2005 thus conflicting with the autonomy law (Figure 5.14).

Figure 5.14: Natural resources revenues and share of natural resources allocated to the education fund (CPI 2005)



Source: SIKD MoF and Province NAD Education

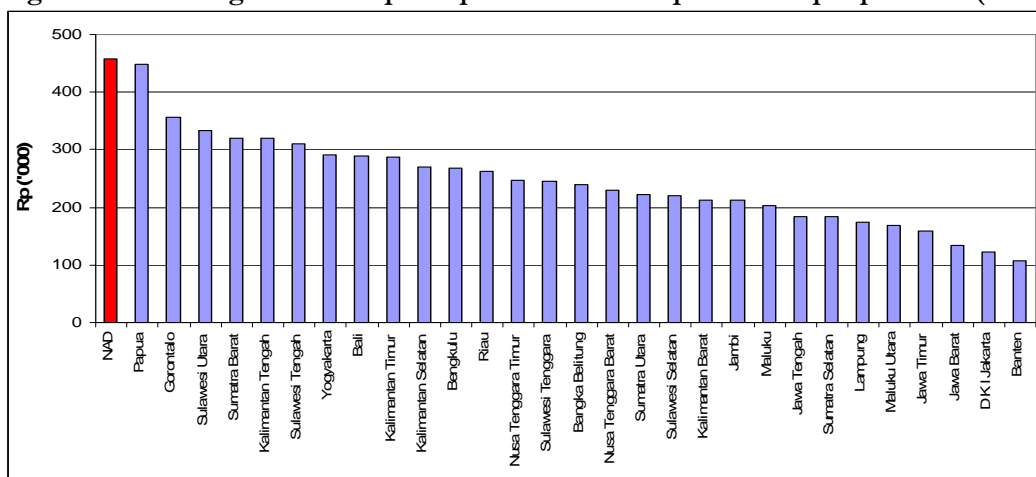
⁹⁹ APBN includes tertiary education, sports, language training, religion, library,

¹⁰⁰ SUSENAS 2005 is not yet available.

Aceh has the highest per capita education expenditures of all provinces in Indonesia. Together with Papua, Aceh province spends significantly more on education relative to its population than all other provinces in Indonesia. A per capita spending of Rp. 457,000 is more than twice the national average of Rp. 196,000 (Figure 5.15).

We cannot say with certainty whether high education expenditure has led to high enrollment rates. One third of provincial and district spending is development spending which could be spent on the construction of facilities, improvement of education supply and other items that contribute to higher enrollment levels. The other two third of provincial and district education spending is routine spending, spent mainly on teacher's wages which has a lower contribution to enrollment levels.

Figure 5.15: Local government per capita education expenditures per province (2004)



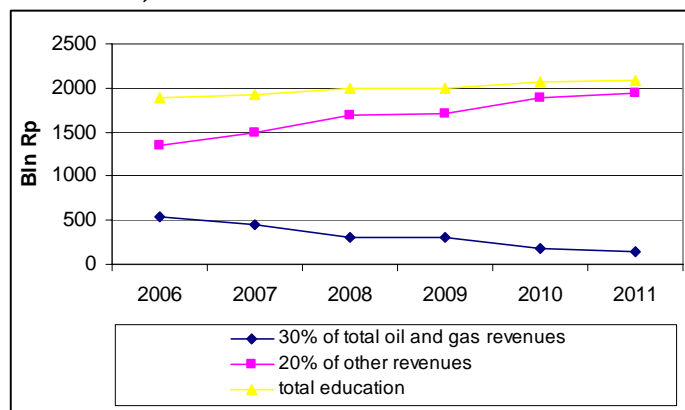
Source: World Bank staff calculations

The new Aceh Autonomy Law No. 11/2006 maintains allocation of funds for education; a minimum of 30 percent of additional revenue sharing should be allocated to education expenses in Aceh and a minimum 20 percent of total province and district government expenses should be allocated to education¹⁰¹. This new law guarantees stable allocation of revenues to the education sector, without any dependence on oil and gas revenues, allowing the education bureaus to plan for the near future. A projection of revenues until 2011 indicates that around Rp. 2 trillion will be available to province and local governments in Aceh for education over the next 5 years (Figure 5.16)¹⁰².

¹⁰¹ **Pasal 182** (3) Paling sedikit 30% (tiga puluh persen) dari pendapatan sebagaimana dimaksud pada ayat (2) dialokasikan untuk membiayai pendidikan di Aceh. **Pasal 193** (1) Anggaran untuk penyelenggaraan pendidikan paling sedikit 20% (dua puluh persen) dari APBA/APBK dan diperuntukkan bagi pendidikan pada tingkat sekolah. **Pasal 218** Alokasi dana pendidikan melalui APBA/APBK hanya diperuntukkan bagi pendidikan pada tingkat sekolah.

¹⁰² In this projection 20 percent of all revenues minus the oil and gas revenues are allocated for education plus the 30 percent from oil and gas.

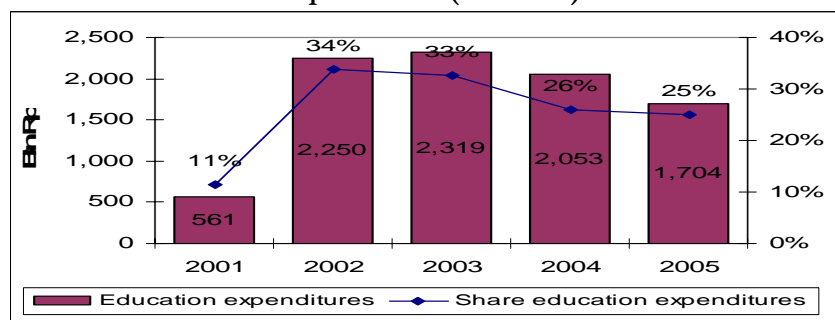
Figure 5.16: Projection of Aceh resources for education 2006 - 2011



Source: World Bank staff calculations.

In absolute terms, regional education expenditures quadrupled after decentralization but then decreased slowly. Nevertheless the share of education expenses in total regional expenses remains above 25 percent. Before the introduction of special autonomy, provincial and local governments managed Rp. 70 and 491 billion, respectively. In 2002, regional resources grew to Rp. 440 billion and Rp. 1.8 trillion, but since then they have slowly declined to respectively Rp. 319 billion and Rp. 1.7 trillion in 2005. The share of education expenses increased drastically after the first Aceh autonomy law was implemented; in 2002, 34 percent of provincial and district expenses was allocated to education. Since then shares have decreased but remain above 25 percent in line with the new Autonomy Law (Figure 5.17).

Figure 5.17: Total regional education expenditures and share of education of total regional expenditures (CPI 2005)

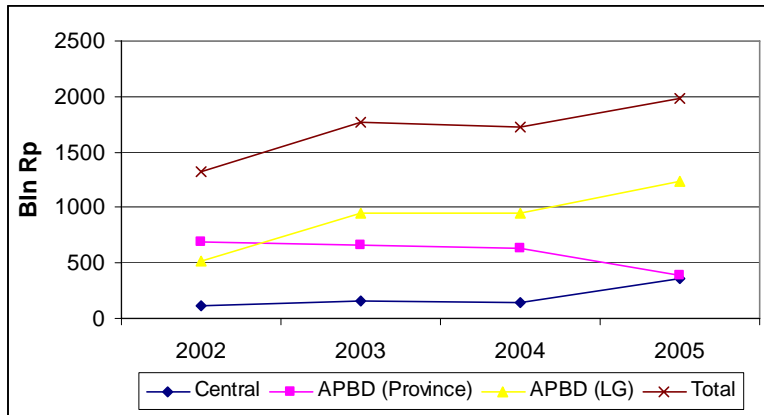


Source: World Bank staff calculations.

Spending by the education bureau has increased since decentralization; local governments contribute the majority of spending. It seems that province education spending after 2004 has decreased due to the pledge of central government to increase spending through the BOS program starting July 2005¹⁰³. (Figure 5.18).

¹⁰³ BOS is a block grant from central government to schools to cover primary and junior school operational costs. Schools sign a Letter of Agreement on the Provision of Aid according to which they have to comply with regulations regarding registration form, principal textbooks and supporting material, costs for teachers' training, exam fees, and other fees. The size of the block grant is determined according to the number of pupils and level of education; Rp. 235,000 per primary school student and Rp. 324,500 per junior secondary student. Schools that did not accept the letter of agreement do not receive any compensation.

Figure 5.18: Trends of education bureau expenditures



Source: APBN, APBD I Provincial education bureau data, APBD of local governments from SIKD also includes cultural spending.

Routine expenses are mainly a district expense, whereas development spending is almost equally divided amongst central, province, and local governments. Local governments spent 74 percent of total routine spending, central government adds another 24 percent, and province contribution is almost insignificant. With 34, 29, and 37 percent the different levels of government make almost equal contributions to education development spending. (Figure 5.6).

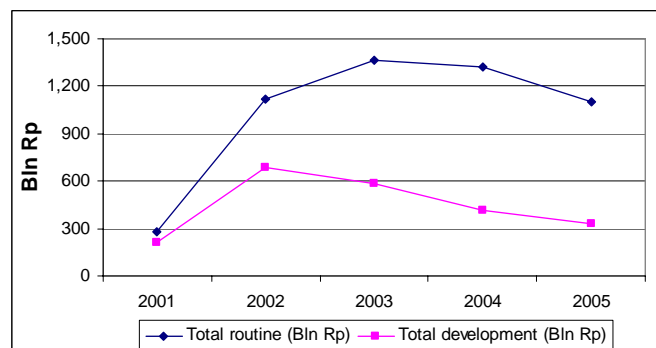
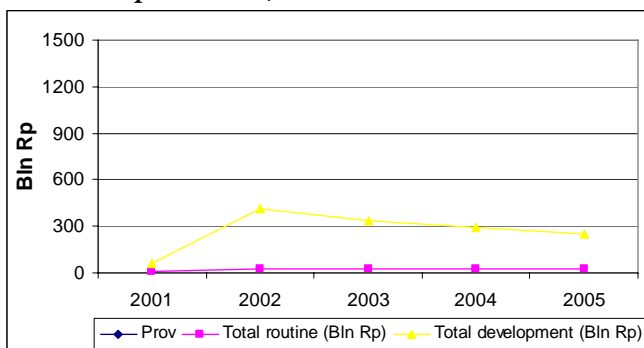
Table 5.6: 2005 Central, Provincial, and District Education spending

	Central		Province		District		Total	
	Bln Rp	%	Bln Rp	%	Bln Rp	%	Bln Rp	%
Total	655	27.8	275	11.7	1428	60.5	2,359	100
Development	298	33.9	253	28.7	328	37.3	879	100
Routine	357	24.1	23	1.5	1100	74.3	1,480	100

Source: World Bank staff calculations

Routine expenditure is taking an increasing share of total education expenditures, leaving little room for development expenditures. Routine expenditures have increased from 2002 onwards. From 2003 onwards more than 60 percent of total regional education expenditures were routine expenditures, in 2005 two third of regional education expenditures were routine (Figure 5.19).

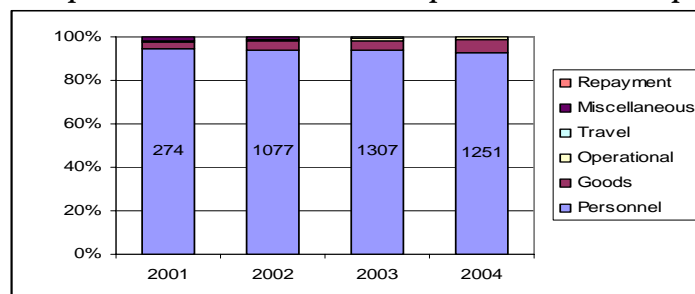
Figure 5.19: Province (left) and district (right) government routine and development expenditures, US\$ million



Source: World Bank staff calculations.

Almost all routine expenditures are allocated to the salaries of teachers. By the end of 2004, 93 percent of routine expenditure is attributed to salaries¹⁰⁴. As a result, goods and operational expenditures for education represent a very small share of the total expenditure. In 2003 and 2004 less than US\$ 10 million was spent on these two categories (Figure 5.20).

Figure 5.20: Specified routine education expenditures in Bln Rp. (CPI 005)

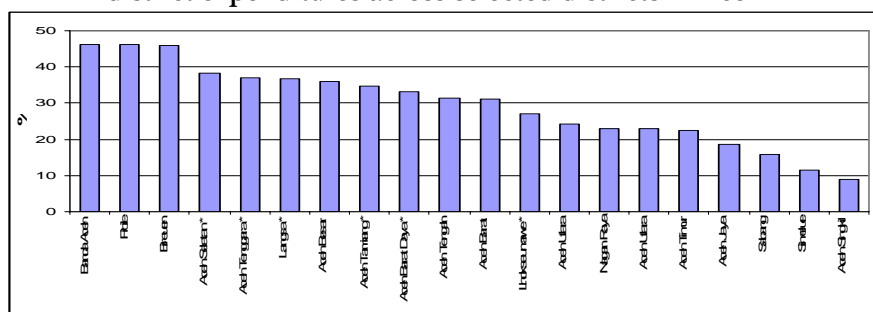


Source: World Bank staff calculations.

The new Teacher Law (No. 19/2005) will increase the expenditures on teacher wages in the coming years. This law stipulates that teachers of all levels of schooling should have a four year diploma or a bachelor degree, envisages that all teachers must be certified within 10 years, and gives additional incentives for teachers who teach in conflict and natural disaster areas¹⁰⁵. The Aceh province would most likely fall under this category. The new teacher law will certainly put additional fiscal demands on the resources for education as higher educated teachers receive a higher base salary.

Local governments on average spend a very significant share of their total expenses on education. Only four districts spent below 20 percent of total expenses on education (Figure 5.21). There are significant variations in education allocations across districts. Many, but not all, districts adhere to the autonomy law (to contribute at least 30 percent of district spending to education). A sample of 334 districts suggests that education expenditure in Aceh's districts are in line with the rest of Indonesia.

Figure 5.21: 2005 and 2004 (*) education expenditures (includes culture) as a share of total district expenditures across selected districts in Aceh¹⁰⁶



Source: World Bank staff calculations.

¹⁰⁴ Breakdown of 2005 expenditures further than routine and development is not yet available but the share allocated to salaries is most likely higher than previous years.

¹⁰⁵ Pasal 29, Law 19/2005

¹⁰⁶ Education expenditures include spending on national culture.

Between 2002 and 2005 a significant portion of the education fund was allocated to government institutions not related to public education, although this trend has been reversed in the last years. Training for government officials and thus not related to schooling was funded through the education fund (highest in 2002 with 14 percent). *Qanun* no. 23/2002 stipulates the use of the education fund for public education only and thus spending not related to education does not comply with Acehnese regulations¹⁰⁷. The number of government institutions benefiting from the education fund has decreased; in 2006 only 7 government institutions received education fund money compared to 21 previously¹⁰⁸. (Table 5.7).

Table 5.7: Allocation of the education fund resources (Real expenditures, Bln Rp)

	2002	%	2003	%	2004	%	2005	%	2006	%
Provincial Education Bureau	220,6	32	245,2	35	243,4	34	193,7	39	161,8	34
Other Departments and agencies	96.5	14	62.4	9	62.3	9	53.7	11	7.2	2
Library and education committee	3.0	0	3.3	0	2.7	0	3.0	1	2.8	1
Universities and training centre	51.2	7	56.0	8	57.7	8	48.8	10	59.4	12
District Education Bureau	279.7	40	262.1	37	264.5	37	196.0	40	228.3	48
Education Heritage fund	49.0	7	70.0	10	70.0	10	0.0	0	0.0	0
Other	0.0	0	2.0	0	5.0	1	0.0	0	20.5	4
Total Education Fund	700.0		700.0		721.4		491.0		480.0	

Source: Dinas Pendidikan NAD 'Perbandingan Alokasi Dana Pendidikan Tahun 2002 – 2006'. 2005 and 2006 are planned budget.

In 2004 and 2005 large shares of the provincial education bureau resources were spent on basic (primary and secondary) education. Even though the share of education expenditure spent on public education has always been above 50 percent, it was particularly high in 2004 and 2005, 79 percent and 86 percent respectively. In 2006, allocation to public education decreased slightly to 66 percent due to the increased allocation on research and development of IPTEK, and the new budget lines development of Islamic education and education management (Table 5.8).

Table 5.8: Provincial spending breakdown 2002 - 2006

	2002	%	2003	%	2004	%	2005	%	2006	%
Primary education and pre school	82	37	56	23	139	54	122	64	107	66
Junior and senior secondary education	41	18	64	26	64	25	42	22		
Tertiary education	10	5								
Extracurricular education / Non formal education / Education for early school children	45	20	48	20	48	18	23	12	21	13
Synchronization and coordination of education development	36	16	57	23						
Research and development IPTEK	7	3	19	8	8	3	4	2	8	5
Development of Islamic education and <i>dayah</i> development									12.7	8
Education management									13	8
Total province	221	100	244	100	259	100	189	100	162	100

Source: provincial education bureau, NAD

¹⁰⁷ The education fund must be allocated to: 1) Pre-Madrasah Education; 2) Primary Education; 3) High Schools and Vocational Schools, 4) Education at Dayah, 5) Higher Education 6) Non-formal Education, 7) Special Schools, 8) Provincial Board of Education (known as Majelis Pendidikan Daerah), 9) Education Trust Fund, 10) Scholarships, 11) R&D in education, and 12) Libraries and School Reading Rooms.

¹⁰⁸ These institutions are the Province Education Bureau NAD, Aceh Special Bureau, National Library Agency, Provincial Education and Training Agency, Regional Education Board, and Islamic Syariah Office.

Public spending on lower levels of education is more pro-poor. Enrollment rates for elementary school are very equal and hardly vary between income groups. Variations between enrollment rates increase with level of education. Junior high school enrollment rates of the poorest income quintile in Aceh are 10 percentage point lower than enrollment rates of the highest income quintile. For senior high school the inequality increases to 25 percentage points; half of the children from the lowest income quintile are enrolled into senior high school, whereas three quarter of the children from the highest income quintile are (Table 5.9).

Table 5.9: Enrollment levels per income quintile (Source: SUSENAS 2004)

Income quintile	SD	SMP	SMA
Poorest	95	76	50
2	96	78	59
3	96	80	61
4	96	84	70
Richest	95	86	75

Education Budget Process

The education budget process remains a top down exercise. The budget process in the era of decentralization has not significantly changed from the past. In theory a system of bottom-up planning is set in place starting from a proposal of the school master, the *musyawarah* to provide community input and then to district, provincial and central government. In reality there is overwhelming evidence of top-down planning.

At all levels education planners are hindered by lack of complete financial information. School officials, both teachers and heads, have become accustomed to wait for public financing, delays in disbursement and uncertainties about the benefits to which they are entitled. This reduces advance planning and the possibility of checks and balances. Schools cannot hold governments accountable when they do not know exactly what they are supposed to receive. District education bureaus are not certain of the financial support they will receive from provincial and central sources until they have actually received the money. At the same time provincial stakeholders lack data from the districts as not all districts send their financial and education data back to the province level.

Slow disbursement of resources drastically reduces the impact of financial flows. All resources experience delays in disbursement varying from months to half a year. Delay in disbursements have in the worst case scenario resulted in the cancellation of the budget item or a delay of spending as a result of which students cannot benefit from the spending from the beginning of their school year.

Recommendations

Aceh spending on education is relatively high in comparison to other provinces in Indonesia. Resources for education will continue to be available; this momentum should be used to increase enrollment into higher levels of education. In the past years education expenditures have been relatively high and this will continue to be the case. The new autonomy law again enforces a minimum allocation to education also the resources available for the tsunami reconstruction create an opportunity to drastically improve education in Aceh. Net enrolment rates for elementary schools are almost 100 percent, whereas higher levels of education have lower outcomes. More attention should be paid to increase access to higher levels of education, where more significant rates of returns can be found.

Quality of education should become a priority for the government. Current data indicates that enrolment rates are relatively high in comparison to national average, but there are clear issues of low maintenance, lack of infrastructure, and low teaching quality. Creating an independent accreditation institution to set quality standards for all levels of education and ensuring that schools obey to their regulations would have a positive impact on quality.

The education bureau is overwhelmed with a large quantity of data but quality data is lacking; identification and collection of key (financial) input, process, and outcome indicators is essential for planning. There remains too much controversy around the actual number of students, teachers, and facilities. Without this basic data, good planning is clearly affected. Although Aceh is a special autonomy region, the provincial government does not have the authority to obtain information from local governments. Reports from local governments to the provincial government are rare and of poor quality, an issue that clearly effects the quality of provincial level reports. The implementation of the 'one roof' education system, where both non-religious and religious education will fall under the education bureau from 2008, provides an opportunity to improve data collection and evidence-based policy making. Data are rarely used for policy making and budget programming at district level, although required by new regulation on budgeting process (Kepmendagri No. 29/2002). Experience throughout Indonesia shows that strong leadership at the local and provincial levels of the Department of Education is required to increase the use of data for policy making and improve quality of education.

Education budget planning and programming is not based on performance indicators. Minimum service standards exist but are not appropriate to information policy. Although district or province achievements on minimum service standards are computed under achievements they are not addressed through policy adjustments. There is a clear over supply of teachers in urban areas and an under supply of teachers in rural areas but this has existed years on end.

Minimum service standards do not necessarily reflect district needs; minimum education service standards should be feasible both practically and financially. The intention to comply with the 9 teachers per school regulation would only reduce the student teacher ratio further, putting additional financial burden on the system without improving efficiency and limiting the flexibility of local governments to provide other solutions to education supply problems, such as regrouping exercises in urban areas and multi-level teaching in rural areas. District needs vary and therefore each district should undertake an assessment of the needs for teachers based on district specific minimum service standards. Such assessments are sparse and the high turnover rate of district heads or heads of education bureaus has proven to limit the sustainability and impact of its results.

Policies to address the uneven distribution of teachers are necessary, the new teacher law in theory increases incentives to teach in remote and conflict areas. Although the education bureau is aware of the uneven distribution of teachers no real attempts have been made to redistribute them. The actual civil servant staffing policies will have to be reevaluated in order to ensure equal distribution of teachers.

More resources should be allocated for maintenance. The share of education resources spent on maintenance is insignificant in comparison to the share spent on teacher salaries. The new teacher law will result in an increasing share of expenditure on teacher's salaries if the number of teachers is maintained.

Non-routine expenditure such as the large allocation of provincial allocation to books in 2006 should be optimized. The provision of books is not a regular expenditure and schools should make use of the allocation wisely. Innovative ideas in how to maintain the books should be

encouraged to prevent quick deterioration. Students and the community should be included to assure maintenance of education facilities and equipment.

In reality authority on spending remains at the centre, the BOS program has increased central authority. A large share of district education expenditure is already earmarked such as financial resources from DAK and the province and district level government do not have the authority to use the money for what they deem is necessary. Bottom-up planning in education with greater participation from all stakeholders, including parents, the school committee, and the local governments should be promoted.

Timely disbursement of financial resources and early and accurate information about volume and time of disbursement is essential. District planners should have timely information about the amount of education resources available to them so that the resources can be used efficiently.

Infrastructure

Aceh's Infrastructure

Even prior to the tsunami of December 2004, Aceh's infrastructure was in poor condition because of a lack of public and private investment; the natural disaster crippled an already deteriorating network. Aceh's inadequate power, water and sanitation, and transportation infrastructure prior to the disaster highlights the lack of economic development in a resource rich region.

Apart from major investments in industries including oil and gas, natural fertilizer, and cement, there was little direct investment by the *private sector in infrastructure*; regional government is the major investor in infrastructure development. Approximately 50 percent of the development budget in 2004 was allocated for improving the regional infrastructure network by building roads and irrigation and sanitation systems. The volume of regional infrastructure spending in real terms has increased from Rp. 452 billion in 1999 to Rp. 1,188 billion in 2002.

Infrastructure development in Aceh is behind national levels on many fronts. Household connection rate to piped water, and the percentage of arable land irrigated are below the national average. However, electrification rates are significantly higher than the national average (Table 5.10).

Table 5.10: Aceh infrastructure indicators compared to national averages

	<i>Aceh</i>	<i>Indonesia Average</i>
Households with access to electricity	74	57
Irrigated land as a percentage of arable land	57	71
Households connected to piped water	9	17

Source: BPS.

The tsunami and earthquake disasters devastated public infrastructure and its services. The disasters extensively damaged the water and sanitation network, regional, *kabupaten*, *kota*, and village roads, irrigated land and irrigation infrastructure such as supply channels and drains and electricity and communication facilities.

The conflict directly damaged some fundamental infrastructure assets and it also affected infrastructure indirectly on several fronts. Many key skills needed to implement projects were not available in Aceh; accountability and transparency could not be guaranteed; corruption became a significant problem; and many resources intended for routine operations and maintenance did not reach intended recipients.

Electric Power

About 25 percent of Aceh's households do not have access to electricity. This is despite the fact that 94 percent of Aceh's 5,800 villages are reported to be electrified. Generally, households are not connected because they are unable to pay high connection fees. A review of eleven regions across the country (with a population of about 156 million) suggests that there is little correlation between village electrification rates and per capita GRDP. Power cuts are common in Aceh and have become even more frequent after the tsunami due to infrastructure damage.

There is insufficient power generation and transmission capacity in Aceh and the conflict further effected electricity supply. Most power comes either from North Sumatra or by (costly) small diesel-powered generators. The national power company, PLN, estimates that as many as 35 electricity generating units were destroyed as a result of the conflict. About 6,751 kilowatts of capacity were lost from a capacity of 71,500 kilowatts as a result of the conflict.

Roads and Transportation

Road transport is dominant¹⁰⁹ in Aceh when compared to other modes of transport. The road network comprises; national roads (1,716 km), provincial roads (1,572 km), and district (*kabupaten*) and village roads (15,340 km). These roads support a relatively flexible transport operation. But, because district and village roads account for most of the network (82 percent), excessive financial pressure is placed on local government to maintain the local network. Inadequate resources and poor resource allocation often lead to inadequate maintenance and deteriorating district roads.

Road density in Aceh is higher than the national average. The road density is 0.5 km/km² and about 7.0 km/1,000 persons; the national average road density is 0.3 km/km² and 1.7 km/1000 persons.

However, roughly 25 percent of the road network is classified as being in poor condition. For national/provincial/*kabupaten* roads the share of roads in poor condition are 31, 46 and 20 percent, respectively (Table 5.11). Unbalanced road development between the western and the eastern part of the province (where oil and gas industries are located), the poor conditions of roads, and an inadequate budget for road maintenance has led to relatively high private and public transportation costs.

Table 5.11: Road Network in Aceh, 2004

Type of Road	Good Condition		Fair Condition		Poor Condition		Total Length	
	km.	%	km.	%	km.	%	km.	%
National	127	7.4	1,052	61.3	538	31.3	1,716.27	100
Provincial	199	12.6	646	41.1	727	46.2	1,571.66	100
Kabupaten	2,995	19.5	9,410	61.3	2,995	19.5	15,339.37	100
Total	3,320	17.8	11,108	59.4	4,259	22.8	18,687.30	100

Source: BAPPEDA.

¹⁰⁹ In terms of tonnages shipped.

The transport sector sustained significant damage as a result of the tsunami. The west coast road linking Banda Aceh with Meulaboh (250 km) suffered the greatest damage. In Banda Aceh alone, 380 km of secondary urban roads were severely damaged. In total, almost 3,000 km of road was classified as impassable. On the east coast the tsunami had less of an impact but the trucks and heavy traffic volumes to bring in materials and supplies for the reconstruction have put increasing pressure on road conditions.

The conflict affected road usage and transportation costs. Regular transportation services were frequently disrupted due to lack of security for users. The frequent blockages of roads and illegal tariffs raised the costs of transporting goods and, at times, closed roads.¹¹⁰

Irrigation

Agriculture provides 24 percent of the province's GDP and it employs 60 percent of the total population.¹¹¹ Prior to the tsunami, there was approximately 465,000 ha of arable land in Aceh¹¹² of which almost 267,000 ha (57 percent) was incorporated into irrigation schemes. Rice is the major crop, with a production of about 1.1 million tonnes per year.

The ratio of arable land to population in Aceh is higher than nationwide (1 ha per 9 people compared to 1 ha per 23 people nationwide). Most irrigation projects (70 percent) are medium to large scale. Only 25 percent is covered by small to medium schemes (150 – 500 ha) and five percent small to very small schemes (<150 ha). The ratio of irrigated land to arable land in Aceh is lower than the nation-wide average.

Aceh falls behind other provinces in terms of implementing irrigation reforms such as transferring responsibility to local Water Users Association (WUA). Traditional water user groups (Keujruen Blang) are responsible for determining the planting period, planting pattern and also managing water use in the irrigation network. According to the Water Resources Service of Aceh, at least 1,125 WUA have been formed; however, the level of responsibility that has been transferred to these groups is uncertain.

Irrigation land and other arable land was affected severely by the tsunami. Apart from the loss of standing crops and livestock, losses also resulted from sediment deposits, seawater inundation, salinity, damage to irrigation and drainage infrastructure, and farm roads. The precise scale of losses (land area affected and reduced productivity) and level of recovery is difficult to determine because the damage occurred over a wide area.

Aceh's exposure to a long-lasting conflict also caused damage to the irrigation system; irrigation networks and water sources were destroyed by the fighting. Some irrigation canals were intentionally damaged which lead to flooding and destruction of agricultural land. Irrigation rehabilitation and upgrade activities had to be suspended due to safety considerations. Maintenance was affected too because of unsafe conditions.

¹¹⁰ Illegal levies on transportation were also imposed by criminal (*preman*) groups.

¹¹¹ National Social and Economic Survey, 1999 – 57.53 percent of males and 67.63 percent of females over 10 years old worked in Agriculture.

¹¹² Includes irrigated and non-irrigated cultivated land but excludes swamps.

Water and Sanitation

Prior to the tsunami, access to formal water and sanitation services in Aceh was low. Only 9 percent of households were connected to PDAM piped water supply¹¹³ compared to the national average of 17 percent.¹¹⁴ Most people obtained water from wells constructed either with their own funds, or by communities/villages with access to project financing. During the conflict years, many households obtained water from military tankers.

All urban and rural sanitation in Aceh is on-site mainly in the form of septic tanks and pit latrines, which are often constructed adjacent to wells. There was limited sludge collection, no waste water treatment, and no urban sewerage in Aceh prior to the tsunami. This is consistent with the rest of Indonesia where only an estimated 1 percent of the population is currently connected to a sewerage system.¹¹⁵

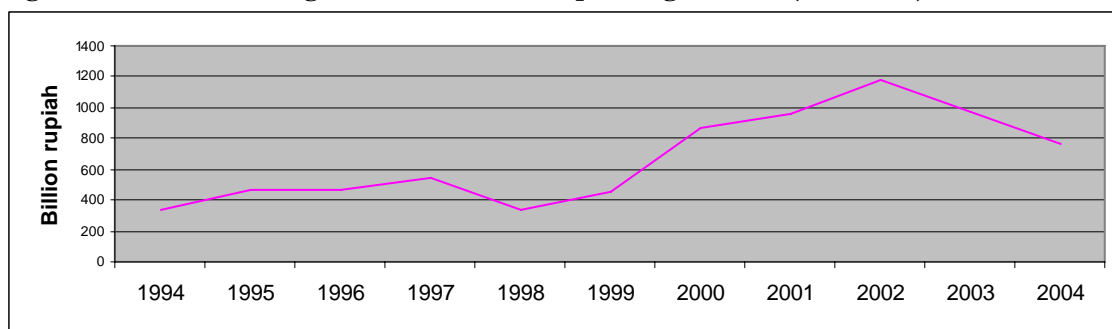
Aceh's already inadequate water and sanitation network, including treatment installations, the piping network, water tankers, and water wells were extensively damaged by the tsunami and earthquake. The tsunami alone destroyed almost 17,000 of the 28,000 pipe connections available in Banda Aceh district. The only sludge treatment plant of Banda Aceh was destroyed. The local level drainage was rendered ineffective because of earthquake-induced land settlement. The majority of the shallow wells and aquifers which were the main source of water to the local population became contaminated and saline. The destruction of 120,000 homes destroyed the related water supply and sanitation facilities.

Infrastructure Spending

Fiscal decentralization in 1999 along with the granting of special autonomy status in 2001 has provided Aceh with considerable additional financial resources. This, coupled with a record financial inflow of resources for relief and rehabilitation, has provided Aceh with an excellent opportunity to improve its infrastructure.

Regional spending (or budget allocations) on infrastructure increased substantially following decentralization and special autonomy to reach more than Rp. 1 trillion but decreased in 2003 and 2004. Infrastructure spending increased in constant prices from an average of Rp. 400 billion in the period before 1999 to almost Rp. 1200 billion in 2002 (Figure 5.22).

Figure 5.22: Trends in regional infrastructure spending in Aceh (1994-2004)



Source: World Bank staff calculations. Data are in real terms (2005 prices).

¹¹³ Some people have piped water not supplied from PDAMS.

¹¹⁴ *Indonesia: Averting an Infrastructure Crises; World Bank Report.*

¹¹⁵ *World Bank paper for presentation to World Water Week; 2005.*

Local government spending on infrastructure has a prominent role in Aceh. After decentralization and the special autonomy, responsibility for most public infrastructure services was transferred to local government. Local government spending on infrastructure as a share of the total spending has been higher than in the rest of Indonesia. (Table 5.12).

Table 5.12: Aceh Infrastructure Spending vs. Rest of the Indonesia

% Total Expenditure	Prov. 2001 (%)	Local Gov. 2001	Prov. 2002	Local Gov. 2002	Prov. 2003	Local Gov. 2003
Aceh	14.25	22.05	16.99	20.25	11.45	16.38
Rest of Indonesia (average)	15.58	11.47	14.82	12.12	14.08	13.91

Source: World Bank staff estimates.

Both volume and share of infrastructure development spending in the total spending declined after 2002. The decline in infrastructure development spending was compounded by reallocations that favored other sectors (Table 5.13). Infrastructure development spending declined from 40 percent in 2001 to around 25 percent in 2004 whereas the government apparatus expenses increased from 12 to 38 percent for the same period.

Table 5.13: Aceh development expenditure by sector

Sector	2001		2002		2003		2004	
	Rp. Billion	%	Rp. Billion	%	Rp. Billion	%	Rp. Billion	%
Government Apparatus	325.7	13.3	795.2	20.7	988.2	29.1	1,189.5	37.8
Education & Culture	398.9	16.3	1,071.4	27.9	920.3	27.1	707.2	22.5
Infrastructure	976.6	39.9	1,187.9	30.9	937.6	27.6	756.1	24.1

Source: World Bank staff estimates. Data are in real terms (2005 prices).

The routine spending, which includes salaries and other operational costs, remained fairly constant since 2001, but development spending declined. Routine spending during 2002-2004 was on average around Rp. 100 billion, or 10 percent of total infrastructure spending, indicating the provincial government's commitment to building up the infrastructure network. However, the development spending declined by over Rp. 200 billion between 2002 and 2004 (Table 5.14). The development budget's decline was also due to the worsening conflict between GAM and the Indonesian Government, which peaked in 2003 after the introduction of the martial law.

Table 5.14: Regional (province and local government) infrastructure spending (bln Rp.)

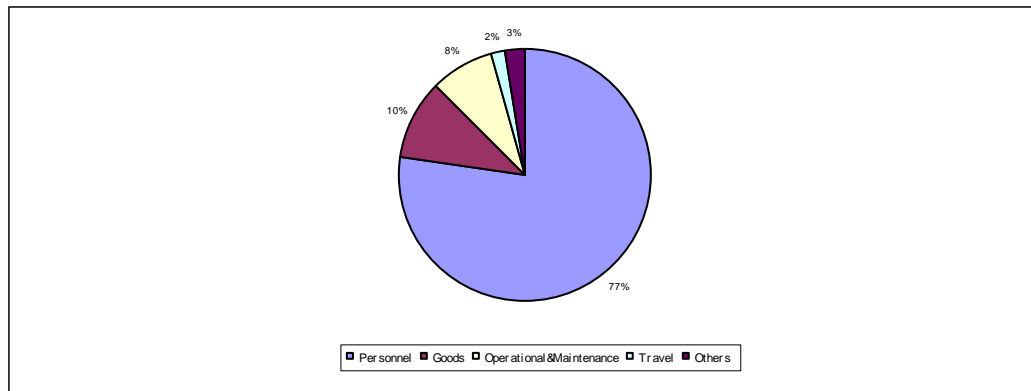
	Routine	Development	Total
2001	56.6	959.8	1,016.4
2002	104.8	1,177.8	1,282.6
2003	101.9	974.5	1,076.4
2004	94.4	767.4	861.9

Source: World Bank data. Data are in real terms (2005 prices).

Routine expenses consist primarily of salaries with little attention being paid to maintaining existing assets. The data show that on average during 2001-2004 salaries accounted for the largest

share of routine spending at 77 percent while operational and maintenance expenses were rather low at 8 percent (Figure 5.23).

Figure 5.23: Average Composition of Routine Expenditure, 2001 to 2004



Source: World Bank staff estimates.

The major issues facing provincial and local government with regard to infrastructure spending include:

- Provincial and local governments seem to be lacking prioritization of infrastructure spending. In Aceh, there is no distinct pattern of infrastructure spending depending on local needs, and the majority of spending is somehow split between public works and transportation.¹¹⁶
- Capacity varies between local government units; staff numbers were generally adequate but with inadequate skills mix and motivation. Lack of technical expertise to perform project planning, implementation, supervision, and maintenance is also an issue.
- BRR presence may lead local governments to spend on development and more on routine.¹¹⁷ However, given the temporary nature of BRR's mandate as well as the transfer of all assets to local and provincial government by BRR there will be significant development and maintenance needs for infrastructure sector at the local government level.

Reconstruction Spending on Infrastructure and the Role of BRR

Funding for rehabilitation and reconstruction of infrastructure comes from the Government of Indonesia, channeling large amounts through BRR, local government, donors- both multilateral and bilateral and NGOs. In overall terms sufficient funds were pledged to meet most needs and to build back key assets better than those which were destroyed. However, the impact of inflation and the less than perfect allocation of resources mean that there are significant funding gaps between sectors and across geographic regions in the province.

Although the reconstruction effort has seen a substantial progress to date, there is still an enormous task ahead. The restoration of public infrastructure has been slower than expected due to several reasons, including the lack of coordination among government agencies before the creation of BRR and the difficulty of settling land titling. Institutional issues—lack of capacity at

¹¹⁶In contrast, Papua, for example, deliberately allocates almost 90 percent of infrastructure budget for transportation development.

¹¹⁷ World Bank paper on Financing and Implementation of Infrastructure Projects; 2006

government level—as well as physical challenges—damaged roads, remoteness of some affected communities—constraints have also delayed the reconstruction effort.

Since the tsunami, prices in Aceh have increased more sharply than the national average. The most dramatic increase is in Banda Aceh where year-on-year inflation in June 2006 was almost 30 percent, down from 41 percent in December 2005. The increase in prices has been mostly driven by increases in transport costs that in turn have been the major determinant in the increase in the cost of construction materials (year-on-year inflation of brick, wood, and sand was 83 percent, 124 percent, and 164 percent respectively by December 2005).

Labor costs also increased significantly in 2005; up 40 to 50 percent across all categories of construction workers. On a less pessimistic note, since January 2006 prices for both material inputs and labor have remained relatively stable at the high 2005 levels but they have not increased significantly since then. The impact of inflation is readily shown by the fact that BRR has increased the average unit cost of new houses from its original estimate of Rp. 28.5 million to Rp. 53 million—an increase of some 85 percent.

As of March 2006, approximately US \$4.7 billion had been allocated by GOI, NGOs, and donors to specific rehabilitation projects for a total minimum need of about \$4.05 billion Infrastructure and the social sectors have received the greatest attention in terms of the allocation of resources. There is an apparent surplus in total available funds to build back minimum needs but hides shortfalls in key sectors and sub-sectors. Infrastructure shows a deficit of available funds for reconstruction of US\$ 653 million. The lack of sufficient funding for the transport sector is clearly a critical issue because an efficient transport network is vital for the delivery of rehabilitation and reconstruction assistance and for overall economic development. There are also significant differences in the availability of funds between regions in Aceh. In some instances regional gaps are more pronounced than sectoral gaps. The areas immediately adjacent to Banda Aceh (Banda Aceh Kota and Aceh Besar) have more than adequate resources to rebuild but other areas are severely under-funded.

Funding critical gaps in infrastructure will likely fall to GOI through BRR and local governments. Many NGOs will complete their reconstruction tasks by the end of 2006 and are unlikely to make further commitments. Similarly, other bilateral and multilateral donors will likely continue to fund projects which they have funded in the previously and concentrate on housing, education, health, and livelihoods.

It is essential that BRR keeps the local and provincial governments involved at all times because they are and will be directly responsible for the present and subsequent operation and maintenance of infrastructure. Deeper involvement of provincial and local governments in infrastructure financing is crucial considering that some major infrastructure projects including major roads and large-scale drainage systems are beyond the capacity of international agencies and NGOs. In addition, current local government allocation of resources does not seem sufficient to the maintenance of assets. Increasing financial capacity of local government should be used to bridge this gap.

Aceh's long-term growth prospects will require local and provincial governments to increase their spending on infrastructure. The restoration of water and sanitation and disrupted power supply services must keep pace with the house building. There is a need for a regional economic development strategy to guide the type and allocation of spending on infrastructure.

Recommendations

BRR will need to involve the local and provincial governments more in the ownership of projects financed by it. This will not only help build local government skills and capacity, but will also ensure that local and provincial governments are immediately involved in the maintenance and upkeep of the newly reconstructed assets. To increase local government ownership, it is recommended that local governments be requested to co-finance infrastructure projects with BRR and other NGOs if possible. Ideally the local government would cover an increasing share of the costs of infrastructure projects over the next years starting from 2007.

Promote a favorable investment climate to attract investments from the private sector in infrastructure. This requires addressing longer-term issues, such as transparent public management and desperately needed legal reforms. The private sector should be encouraged to undertake some of the major projects as part of the current overall reconstruction and rehabilitation program for Aceh.

Technical and institutional absorptive capacity constraints should be addressed. Weak capacity of local governments limits the realization of increases in spending despite the fact that funding is readily available. Technical assistance projects by donors and other agencies will be critical to help ensure local governments are well prepared and have the capacity to implement high quality projects. This executing and implementing capacity will need to be maintained after 2009 when the reconstruction process will be over. The infrastructure development plans need to be socialized down to sub-district level such that coordination is improved and responsibility is handed over efficiently.

Guarantee infrastructure maintenance of the existing assets and those currently under construction. The issue of maintenance is an utmost priority in order to ensure sustainability and to avoid decay of existing and newly developed infrastructure. An optimum balance will be required between routine (maintenance) and development expenses to move forward. This also will require strategies for local and provincial governments to have ownership and buy-in of all the projects that they will be left with after the donor-financed reconstruction is over.

In order to make infrastructure spending more effective, the local government and BRR will need to prepare a long term plan for infrastructure development in the province, including greater coordination between provincial and local governments. In the short to medium term, BRR will be in the driver's seat of reconstruction and development of infrastructure in the region, but in the medium term local government must develop its capacity as a regulator and planner, as an investor in selected infrastructure sub-sectors, and most importantly, as a policy maker. It will be useful to develop a medium-term fiscal and expenditure framework that will determine the expenditure ceilings over the medium term—both for capital and current expenditures on operations and maintenance. This framework will need to specify expenditures over a longer time period in accordance with the revenue forecast.

Monitoring and evaluation systems should be strengthened. The first eighteen months of rehabilitation and reconstruction may have resulted in more cost effective and sustainable infrastructure if monitoring and evaluation systems had been more robust. The sector must establish a workable monitoring and evaluation system which can be utilized by all projects at all levels of implementation; national through to the *kabupaten*.

6. LOCAL GOVERNMENTS' CAPACITY TO MANAGE BUDGET FUNDS

Decentralization: the workload of local government has increased in terms of quantity and quality

Local Governments need to improve the skills of their staff while the need for additional staff is less pronounced. Decentralization has changed the type of work local governments have to perform. Staff may require new or additional training to perform these new responsibilities. Decentralization has not only shifted responsibilities to the local governments but also increased the number of administrators and resource available. Managing decentralization should thus not require additional staff. Special Autonomy does provide additional financial resources and additional staff may be required to administer these funds.

Decentralization has added to the workload of local governments but the transfer of additional human and other resources has ensured that administrative workloads were similar after decentralization. Decentralization has granted control of local government finances, regional civil service, and organizational structure to the local government.¹¹⁸ The provincial government embraces the “de-concentration” role in the sense that the provincial government also serves as a representative of the central government.¹¹⁹ In addition, the decentralization laws stipulate that central government agencies at the regional level must merge with the respective agencies of the regional government. Thus, all assets and staff of the previous agencies were transferred to the regional governments.¹²⁰ While there has been a large shift of responsibilities to local government, the parallel shift of resources and staff has ensured that local government staff do not perform additional amounts of work, they are only under a different authority.

After decentralization there is a need to improve administrative skills at the local level because the type of work performed by local governments has changed. Prior to decentralization the local governments were merely representatives and implementers of central government's policies and programs (GTZ, 2003). With decentralization, the new task of local governments is to analyze the needs and identify priorities for their regions, which require better skilled and trained staff. Local government administrators need to build up their capacity and experience in policy formulation and effective resource allocation.

Limited Impact of the Conflict and Tsunami on district administrations

Local government administrations did not suffer extensively from the long-standing armed conflict and the earthquake/tsunami. Village and sub-district administrations, however, did suffer quite severely. But more than administration capacity the delivery and supervision of public services was hampered due to damage to facilities or due to threats and extortion.

The conflict had a profound impact on the operations of the local government, especially in the rural areas. It is estimated that at the peak of its operations GAM successfully controlled between 70 and 80 percent of the Province of Aceh, including its local governments, through the intimidation of civil servants at all levels of government. It was reported that 3,500 out of the 5,000

¹¹⁸ The decentralization of Indonesia was embodied in the law No. 22/1999 on decentralization and law No.25/1999 on financial balance between Central and Local government.

¹¹⁹ GOI, 1999a.

¹²⁰ GOI, 1999.

village heads were under the GAM control, and virtually none of the *kabupatens* had a fully functioning administration.¹²¹

There exists no detailed assessment on the impact of the long-running conflict in Aceh on the public financial capacity. A larger survey sample and data from other sources would be needed to make such an assessment. However, anecdotal evidence seems to support a hypothesis that a high intensity of conflict and/or presence of GAM had hampered government functions mainly due to travel restrictions: administrators could not stay in their villages, supervisors could not check on implementation and planning information could not be collected.

The conflict also resulted in a huge financial burden to replace public service infrastructure. Mostly physical public structures (especially schools) were destroyed. In the education sector alone, given that as many as 1,000 schools were destroyed or damaged (Schulze, 2004), the loss was estimated to be at least US\$ 35 million. Administrative buildings were rarely attacked and largely escaped from conflict damage.

A further fiscal burden was imposed through extortion activities committed by the conflicting parties. According to some accounts, the conflicting parties skimmed an estimated 20 percent off the development funds allocated by the central government for development projects implemented in Acehese villages. This was done by demanding fees (often through threats) from the contractors working on government projects.¹²²

According to the Rehabilitation and Reconstruction Agency (BRR), 5,266 civil servants died in the tsunami. Most of the victims were staff delivering public services and extension workers, fewer administrators were killed.

District administrations did not suffer due to a lack of staff after the tsunami. As early as five months after the tsunami, all tsunami victims holding administrative government positions had been replaced. Most of the victims were in the lower echelons that are relatively overrepresented in the local government hierarchy.¹²³ However, several district leaders themselves mentioned that the mechanism in selecting officials to fill in positions is not clear and transparent. They admitted that it is commonplace to find officials occupying high-level positions without the relevant and adequate educational background or experience. In some districts, it was mentioned that the changes in government apparatus are too frequent, affecting officials' motivation.

The tsunami severely damaged physical infrastructure but not at the district level. The destruction of government physical structures in the ten sampled *kabupatens* was mostly centered on *kecamatan* offices. Again public service infrastructure suffered more than buildings used by the administration. Some administrative line agencies from Kab. Aceh Jaya, Kab. Simeulue, Kab. Banda Aceh and Kab. Aceh Singkil were damaged. The local government administrative line agencies in the other *kabupaten* were mostly undamaged.

Local governments were fairly responsive in the emergency relief phase, but were not proactive enough in the reconstruction process. In three of the worst hit districts (Kab. Aceh Besar, Kab. Simeulue, and Kab. Aceh Jaya) the community saw that the district leaders mobilized people to

¹²¹ Schulze, 2004.

¹²² Ibid.

¹²³ This finding is based on the joint World Bank/local NGO survey that focused on six sampled government agencies (public works, health, education, planning, agriculture and fisheries) in ten local governments (Banda Aceh, Aceh Besar, Aceh Jaya, Aceh Barat, Nagan Raya, Aceh Singkil, Pidie, Bireuen and Aceh Utara). In 58 line agencies assessed, there are 3,869 government employees or 67 staff per office on average.

assist in the evacuation of victims and to participate in the clean up process of their district. However, local governments failed to gather information on the needs of its people and develop a clear reconstruction strategy. Local governments did not allocate their resources effectively to rebuild their districts and expressed the expectation that reconstruction would be taken on mainly by higher levels of government or the international community.

Administrative Capacity is weak in general; external audit and regulatory framework are the weakest.

In the face of substantial increase in funds and the authority to manage the funds, the capacity of local governments to efficiently manage public funds remains weak. This is indicated by the results of the Public Financial Management (PFM) Survey,¹²⁴ which assesses local governments' financial management capacity, regulatory framework and accountability.¹²⁵ The PFM Survey does not thoroughly measure available equipment and infrastructure, but government officials say a lack of working equipment hinders the planning and budgeting process. Buildings are generally considered sufficient and are not mentioned as a constraint for the administration.

On average, capacity of local government in managing public funds is weak. The average overall scores for managing public funds among the five local governments surveyed is 41 percent.¹²⁶ The two highest scores are Kab. Banda Aceh (59 percent) and Kab. Aceh (53 percent) Besar, while the lowest is Kab. Aceh Jaya (19 percent). In Aceh, on average, the highest scores were obtained for procurement and internal audit (58 percent and 52 percent respectively). However, the system for taking care of complaints relating to the procurement process or results in the local government is still weak (score 33 percent). Moreover, community leaders in eight out of ten districts interviewed, identified procurement as most prone to a lack of transparency.

The lowest scores were obtained for external audit and regulatory framework (29 percent for each strategic area). In more detail, the PFM results reveals that the local governments have weak regulatory framework to enhancement of transparency and public participation (grade 23 percent), to manage public funds effectively (30 percent) and to enforce rules and organizational structures (31 percent). External audit is weak because routine external audits (score 25 percent) and effective independent oversight are lacking (score 32 percent). Just as an illustration: All surveyed district governments (except Nagan Raya and Singkil) mentioned that the budget is a public document and is available to the any interested party. However, the PEA team found that access to the district budget without accompanying high-level authorization is limited.

Local government is also weak in planning and budgeting as well as in accounting and reporting. The weakest link in the planning and budgeting process is the connection between the budget and the medium-term plan. (score 20 percent). This means that funds are effectively not used to reach medium-term development goals. The consistency between participative bottom up planning, local government planning, local government sectoral planning and the budget is also weak

¹²⁴ The PFM survey was conducted between May 22 to June 2, 2006 in Banda Aceh, Aceh Besar, Aceh Jaya Aceh Barat and Nagan Raya districts. The PFM framework was developed by World Bank and Government of Indonesia's Ministry of Home Affairs.

¹²⁵ The PFM framework and methodology are discussed in detail in the Annex. The framework is divided into nine strategic areas key to effective management of public finances at district government: (1) Regulatory framework, (2) Planning and budgeting, (3) Cash management, (4) Procurement, (5) Accounting and reporting, (6) Internal audit, (7) Public debt and investment, (8) Assets management, (9) External audit and oversight.

¹²⁶ The scores can be interpreted as follows: 0-19 percent - poor/poor/not acceptable; 20-39 percent - moderate/moderate/partially acceptable; 40-59 percent - good/good/fairly acceptable; 60-79 percent - very good/very good/substantially acceptable; 80-100 percent - excellent/fully acceptable.

(score 26 percent), which is indicative of an ad hoc use of funds rather than a coherent strategy. In addition, system for participation are not in place (score 24 percent) and accounting and reporting capacity is very weak (score 6 percent). Overall, community leaders mentioned that the process of eliciting public input in the public hearing to formulate the district project plans is perceived to be a formality, and they perceive that the line agencies have already have a set of project plans to be proposed into the district budget.

Table 6.1: Results of the PFM survey in 5 sites in Aceh (in percent)

Strategic Area	Nagan Raya	Aceh Barat	Aceh Jaya	Aceh Besar	Banda Aceh	Average Score for all five Local governments
Regulatory Framework	12	8	20	56	48	29
Planning and Budgeting	25	26	25	42	53	34
Cash Management	23	50	14	48	70	41
Procurement	60	69	33	62	67	58
Accounting	19	22	11	59	59	34
Internal Audit	67	61	11	67	56	52
Public Debt and Investment	13	50	0	38	50	30
Asset Management	41	64	14	45	41	41
External Audit and Oversight	0	0	11	67	67	29
Average	33	42	19	53	59	41

Source: PFM survey.

Local Governments often lack of working equipment to work effectively. In addition, government officials often mention the lack of proper equipment as a hindrance to the planning and budgeting process. Buildings are generally considered sufficient and are not mentioned as a constraint for the administration. In interviews district staff emphasized that they experienced difficulties in obtaining accurate data from the field due to limited resources.

Local governments' staff educational attainment is reasonable

Qualifications level of government officials in Aceh is reasonably good compared to the rest of Indonesia. Our analysis shows that education attainments levels of government employees in Aceh are higher than the national average, although this does not apply any more in the higher attainment levels. (Table 6.2).

Table. 6.2: Educational attainment of government employees in Aceh (2003, in percent)

	<SLTA	SLTA	DIPLOMA	S1	S2	S3
Indonesia Average	5.41	41.13	25.06	26.07	2.14	0.19
Aceh	4.39	37.38	23.46	32.76	1.86	0.16

The distribution of staff qualification between districts is relatively even although some differences remain. There are large differences in terms of the number of staff in each local government, with Pidie having the largest number of staff (11 percent of total government staff in Aceh) and Gayo Lues and Aceh Jaya having the smallest number of staff. Staff in *kota* have the highest education attainment levels followed by government staff in old *kabupaten* and then staff in new *kabupaten*. (Table 6.3.)

Table.6.3 Qualifications of government staff in Aceh (2003)

	<SLTA (% Kab/Kota staff)	SLTA (% Kab/Kota staff)	Diploma (% Kab/Kota staff)	S1 (% Kab/Kota staff)	S2 (% Kab/Kota staff)	Total staff (%)
Overall	3.77	31.22	20.78	25.17	0.57	
Kab. Aceh Selatan	4.03	39.46	26.99	28.72	0.79	4.84
Kab. Aceh Tenggara	5.62	50.05	20.42	22.88	1.02	4.37
Kab. Aceh Timur	8.28	39.34	24.24	27.91	0.23	4.47
Kab. Aceh Tengah	3.53	38.77	29.90	27.34	0.45	6.36
Kab. Aceh Barat	3.29	40.16	26.64	29.25	0.63	5.00
Kab. Aceh Besar	2.78	34.75	24.81	36.43	1.20	8.71
Kab. Pidie	6.59	32.66	27.40	32.86	0.49	10.67
Kab. Aceh Utara	6.72	39.53	24.76	28.84	0.15	5.86
Kab. Simeuleu	2.88	47.53	24.74	24.45	0.40	1.65
Kab. Aceh Singkil	2.64	42.42	19.74	34.24	0.97	2.17
Kab. Bireuen	4.57	33.35	30.19	31.62	0.26	7.04
Kab. Aceh Barat Daya	4.15	33.27	33.75	27.87	0.96	1.97
Kab. Gayo Lues	4.91	43.18	24.78	26.10	1.03	1.30
Kab. Aceh Tamiang	3.72	35.80	28.89	31.25	0.33	2.87
Kab. Nagan Raya	4.27	41.88	28.70	24.74	0.40	2.12
Kab. Aceh Jaya	4.75	39.55	28.21	27.21	0.28	1.34
Kota Sabang	6.27	43.36	17.20	32.29	0.88	2.06
Kota Langsa	3.32	39.90	19.99	35.58	1.17	4.08
Kota Lhokseumawe	2.82	39.33	17.16	38.81	1.85	4.63

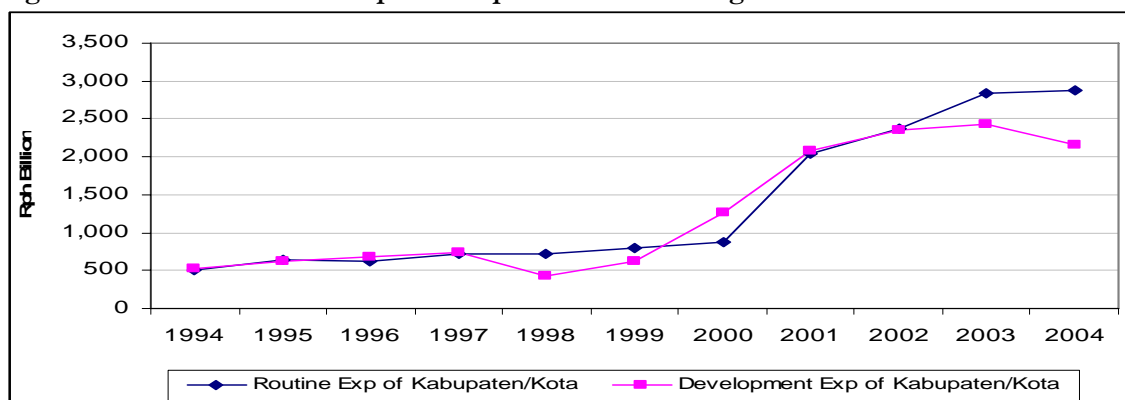
Local Government Spending Patterns

Routine vs. development expenditure

While there is no apparent need for additional staff, staff costs have increased. And while the needs for post-conflict and post-disaster reconstruction is in public services, capital investment in public services is decreasing. Since decentralization personnel costs have crowded out capital investment for public services. Expenditure on personnel has increased disproportionately while operational expenditure has barely increased. Development expenditure for public services has fallen but continues to rise for administrative investments. Both these trends are contrary to the needs identified above.

Routine expenditure has overtaken development spending. The Indonesian budget format consists of two main components: Development covering capital investment and routine expenditure covering recurrent cost including maintenance and personnel. As can be seen in the chart below, both routine and development spending increased more or less equally until 2002. However, in 2003 routine expenditures overtook development expenditures and routine expenditures continue to rise while development budgets are falling. (Figure 6.1).

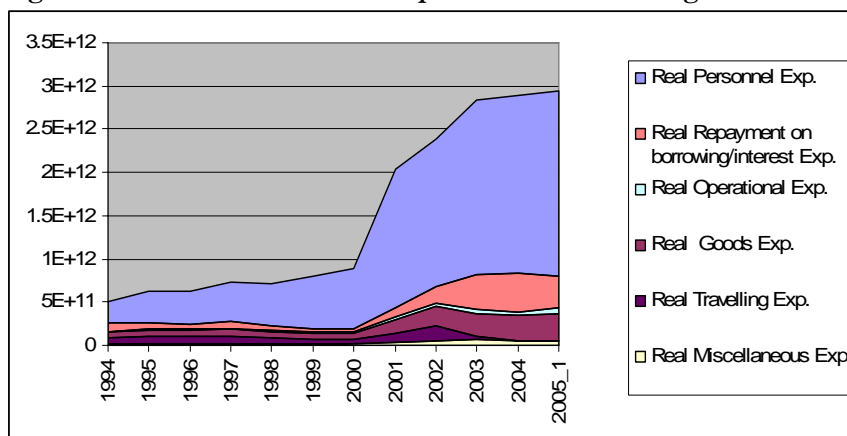
Figure 6.1: Routine and development expenditures of local governments



Source: World Bank staff estimates. All data are in real terms (2005 prices)

Most of the total increase in routine expenditure has been driven by the increase in expenditure on government personnel. The share of expenditures on personnel in the total routine expenditures has jumped from 13 percent in 1994 to 40 percent in 2004. (Figure 6.2). The challenge for local government has been identified as the capacity of available staff and not the number of staff. Decentralization and special autonomy have increased the need for better qualified administrators rather than more administrators. The PFM survey also identified the weak administrative capacity as a problem. The allocation of public resources to increase the number of staff is thus not serving a need.

Figure 6.2: Structure of routine expenditures of district governments

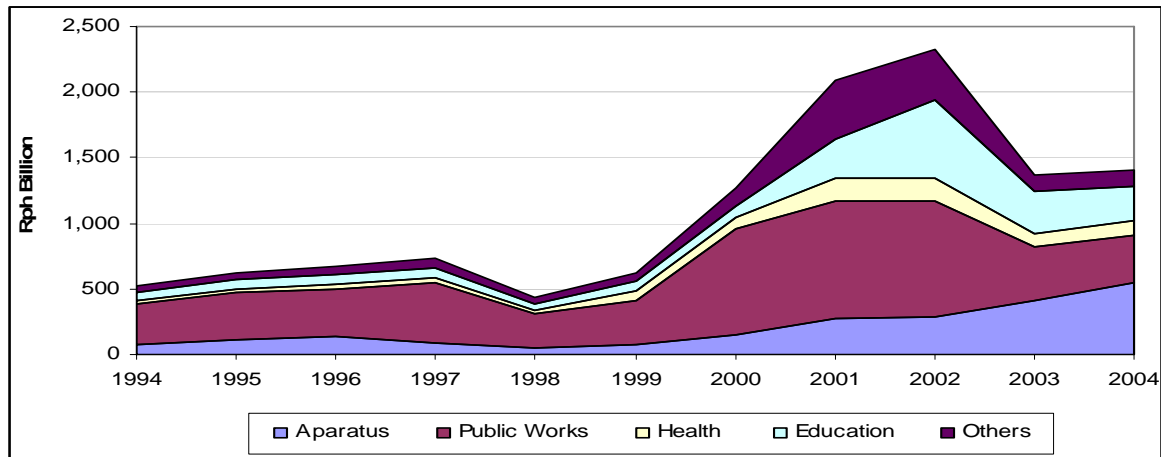


Source: World Bank staff. All data are in real terms (2005 prices)

Development expenditures on government apparatus continued to rise even while expenditures on infrastructure declined. In 1994 the spending on physical investments for general administration was approximately a quarter of funds allocated for public works. By 2004 spending on the government apparatus had surpassed public works spending. In fact, it constituted nearly half of

total development expenditures of local governments. Since 2002 the development expenditures for apparatus¹²⁷ (Sektor Aparatur Pemerintah) continued to rise despite declining total development expenditures (Figure 6.3). The conflict and the tsunami mainly damaged public service infrastructure while the administrative infrastructure remained was not damaged to such an extent. The overall shift of capital investment in administrative apparatus is thus contrary to the identified needs.

Figure 6.3: Structure of and trends in development expenditures



Source: World Bank staff. All data are in real terms (2005 prices)

Proliferation of districts: causes and consequences

The mushrooming of *kabupatens* and *kecamatanans* is unnecessary and costly, causing increased administrative and personnel cost. The growth of administrative bodies is mainly driven by rent-seeking and is made possible by legal loopholes. The capacity of staff in newly established *kabupatens* is lower than in the older ones. The proliferation of administrative structures further reduces the already low capacity of local governments while decentralization and special autonomy have increased the need for highly qualified administrators.

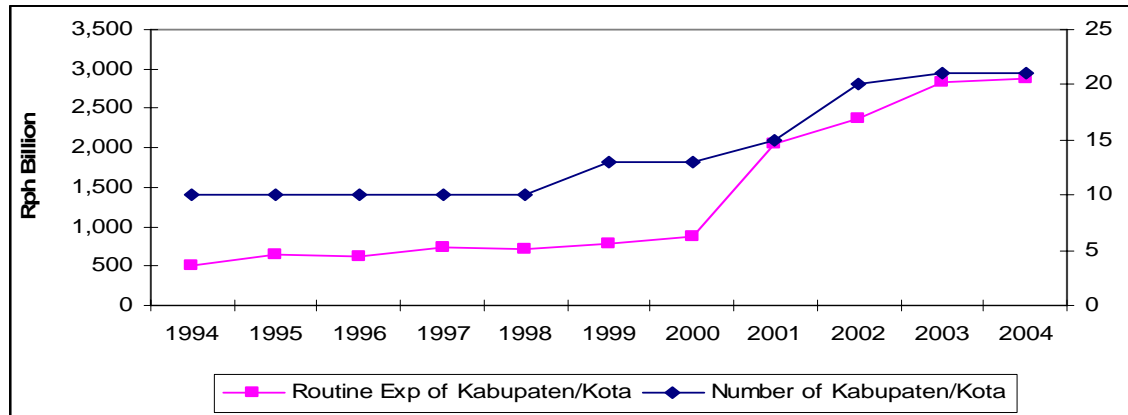
Since the beginning of decentralization, the number of districts (local government) and sub-districts within Aceh Province has increased. Prior to decentralization, there were 10 local governments within Aceh Province. By 2003, the number of local governments had increased to 21. In addition there was a growth in the number of *kecamatanans* (sub-districts) within the *kabupatens*. With the exception of one *kota* (Sabang), all local governments have increased the number of *kecamatan* in their area. As a result, the number of *kecamatan* in Aceh Province nearly doubled from 140 in 1999 to 235 in 2005.

The continuing increase in routine expenditures relative to development expenditures was largely driven by the increase in the number of local government and *kecamatanans*, causing a corresponding expansion in the number of government structures and the creation of new echelon positions. The data show a close correlation between the trends in routine expenditure and the number of local governments (Figure 6.4).

¹²⁷ The development spending for apparatus represent expenditures on investments in physical infrastructures and equipment for government administrations operations. Among others, these expenditures include the purchase of government office buildings for general government administration and official cars for heads of districts and agencies.

The number of *kabupaten* and the related routine expenditure really take off once decentralization provided for the necessary funds. The proliferation of Local governments commenced in 1998 but it did not result in a notable increase in routine expenditure. As the implementation of decentralization (and the shift of authority and funds to local governments) went under way in 2000, the spending for routine expenditures significantly increased.

Figure 6.4: Routine expenditures and number of local government



Source: World Bank staff. All data are in real terms (2005 prices).

The proliferation in the number of local administrations is mainly driven by rent-seeking and is made possible by legal loopholes. While local governments justify the additional structure with geographic needs and improved government services, the opportunity to appoint new bureaucrats and obtain additional allocation from the center is driving the proliferation. The establishment of new administrative structures through a parliamentary initiative allows for additional districts without proper checks.

The establishment of a new *kabupaten* does not improve the delivery of government services. Governments often justify the establishment of additional administrative structures arguing that public service would improve. However, the PFM survey shows that government capacity in the newly established *kabupaten* is much weaker than in the older *kabupaten*. The separation of urban areas from the more rural periphery into a *kota* and a *kabupaten* has been defended with the argument that *kotas* have different service needs compared to *kabupatens*. Again the PFM survey proves that the *kabupaten* have less capacity once they have been separated from their urban center.

The increased central government allocation and rent-seeking opportunities are more likely the driving force behind the proliferation of districts. The sum of the funds allocated by the central government to two divided *kabupatens* can be larger than the allocation to the original *kabupaten*. This creates a strong incentive for local governments to separate. Moreover, every local government is allowed a number of echelon positions. This provides an opportunity for the government leaders of the new local government to appoint new bureaucrats to echelon or sub-district (*kecamatan*) positions. Finally, the project management and procurement is under the authority of the new local government, thus potentially providing opportunities for rent seeking activities.¹²⁸

The establishment of new districts using a parliamentary initiative bypasses the requirements stipulated by law. Law No. 129/2000 on the separation and amalgamation of regions stipulates the requirements for the establishment of new districts including the approval by

¹²⁸Fitriani et al. 2005.

the originating *kabupaten*. This stipulation serves as a counterbalance to prevent a burgeoning in the number of local governments. This requirement is followed by a technical evaluation of the merits of the proposal by the central government's Regional Autonomy Advisory Council (DPOD) based on 40 indicators. The results are then presented to the president for endorsement before being submitted to parliament to be passed as national law. In addition, the decree stipulates that a new *kabupaten* must consist of a minimum of three *kecamatan*.¹²⁹ However, there is an alternative method for setting up a new local government, which is through a parliamentary initiative. This approach appears to have enabled those promoting the establishing a new local government to bypass the requirements to obtain prior approval from the originating local government.¹³⁰ Anecdotal evidence indicates that this method is less transparent than the first.¹³¹

Local Government capital expenditures

Contrary to the needs identified, local governments spend little on training while a major share of their capital investment goes to buildings, equipment and vehicles. While the PFM survey has identified skills development as a priority, spending for training takes only a marginal portion of the total budget of local government. On average, the local governments spent less than 25 percent of their total budget on capital investment expenditures. Among those, more than half are spent for capital investments on buildings, equipment and vehicles. The construction of new buildings dominates local governments' capital expenditures, despite not being identified as a priority need.

The new budgetary format, performance-based budgeting, has been in place since 2003 therefore there are only four years of budget data available for analysis. This new budget format divides spending between apparatus and public spending. Each category of spending is further divided into three subcategories: general administration (*administrasi umum*), operation and maintenance (*operasi dan pemeliharaan*) and capital investment expenditures (*belanja modal*). The subcategories general administration and operation and maintenance are further broken down into several categories, among others personnel expenditure (*belanja pegawai*), which has human resources development (*biaya pengembangan sumber daya manusia*) as a sub-item. Capital investment expenditure is also broken down into several categories specifying the types of capital investment. This section focuses on personnel expenditures, in particular on expenditures for human resource development and on capital investment expenditures and its sub-items.

On average, local governments spend only 1.29 percent of their total budget for expenditures on development of human resources. The weak capacity identified by the PFM survey and the increased need for highly qualified staff after decentralization would suggest that a larger investment in staff development are warranted.

Among the three types of capital investment, the largest share was spent on buildings. On average local governments spend less than 25 percent of their total budget on capital investment (combined apparatus and public services). Half of this amount is spent on buildings, equipment and vehicles. Capital investment expenditures for building are dominant among the three spending types, with average share being 63.68 percent. This expenditure is followed by capital investment on equipment and vehicles expenditures (22.09 and 16.52 percent respectively, table 6.4)

¹²⁹ GOI, 2000.

¹³⁰ Fitriani *et al.* 2005.

¹³¹ A particular case refers to a former *bupati* of Riau Island *Kabupaten* (which is currently a province), who was a prominent initiator for the establishment of the Province of Riau Islands.

Table 6.4: Share of capital investments for buildings, equipment and vehicles

Year	Capital Exp. as % APBD	Building as % of Capital Exp.	Equipment as % of Capital Exp.	Transport as % of Capital Exp.
2003	20.52	57.06	21.19	21.75
2004	22.85	79.20	14.38	13.46
2005	28.10	53.51	28.19	16.56
2006	28.80	64.93	24.60	14.31
Average	25.07	63.68	22.09	16.52

Source: World Bank staff

Bearing in mind the limited sample in this exercise, the results still show that while staff in new *kabupaten* have less administrative capacity, these districts spend less on human resource development and more on buildings. So new *kabupaten* spend even more on less urgent types of capacity building. Old *kabupaten* spend more on training than while it is the newly formed *kabupatens* that need it more.

Table. 6.5: Share of expenditures for development of human resource out of total local government budget

Year	Av. training exp. as a % of APBD (all local government)	Av. training exp. as a % of APBD (old local government)	Av. training exp. as a % of APBD (new local government)
2003	1.06	1.36	0.66
2004	1.30	1.23	1.57
2005	2.00	2.52	0.94
2006	1.42	1.58	1.21
Average	1.29	1.44	1.03

Source: World Bank staff

New local governments spend slightly more on buildings and vehicles but much more on equipment. The average capital investment spending for buildings out of the total budget for old local governments is 6.7 percent. For new *kabupaten/kota*, the share is similar: 7.29 percent. Older local government spends around 2.3 percent of their budget for equipment while newer *kabupatens* spend twice as much. On average new local government spends 2.56 percent of their total budget for purchasing vehicles. Older *kabupaten* and *kota* spend somewhat less, with 2.2 percent out of total budget. It is worth noting that local governments spend more than twice as much on new vehicles than on training.

The results indicate that new local government have substantial set up costs, as indicated by the relatively higher spending on capital investments in buildings, equipments and transportation vehicles as a proportion of local governments' total budget by new *kabupaten/kota*.

The lion's share of expenditures on equipment and vehicles also go to the administration rather than to the public services. On average, the administration absorbs about 43 percent of the

capital investment for equipment and 70 percent of the capital investment for vehicles. These expenditure are very hard to defend in view of the established needs in education and health.

District Leaders' and Community Perceptions of the Key Issues in the Budget Process¹³²

The standard public hearing mechanism itself does not ensure adequate community participation in the budget process. All district leaders mentioned that they had elicited public opinion through the standard public hearing mechanism (*Musrenbang*). However, some district leaders mentioned that the *Musrenbang* process was not effective because the village leaders who are participants in the public hearing at the subdistrict level do not know how to determine their needs. Most of the projects proposed by the village leaders went to “their wants rather than real needs”.

Lack of working equipment and skills is often mentioned as a hindrance to the planning and budgeting process. Three districts (Kab. Aceh Besar, Kab. Singkil and Kab. Nagan Raya) mentioned that the lack of vehicles was a constraint. Three districts (Kab. Nagan Raya, Kab. Aceh Barat and Kab. Aceh Jaya) emphasized that they experienced difficulties obtaining accurate field data due to limited resources. In two districts (Kab. Bireuen and Kab. Aceh Utara) the conflict was identified as a major hindrance in the process of gathering community input and this reduced the districts' ability to expand and improve the delivery of basic public services.

There is a lack of transparency in appointing and replacing local officials, coupled with the problem of frequent changes in personnel. Several district leaders mentioned that the mechanism of selecting officials is not clear and transparent. It is commonplace to find officials occupying high-level positions without the adequate or relevant educational background or experience. In some districts, it was mentioned that the changes in government apparatus are too frequent, affecting officials' motivation.

Authorities in most districts stated that budget documents are, in principle, publicly available, although it is not clear to what extent this is the case in practice. All surveyed district governments (except Kab. Nagan Raya and Kab. Singkil) mentioned that the budget is a public document and is available to the any interested party. However, anecdotal evidence suggests that in many cases access to the district budget without accompanying high-level authorization is limited.

There is very little or no role for the community in the planning and budgeting process. Overall, the community leaders mentioned that the process of eliciting public input in the public hearing to formulate the district project plans is perceived to be a formality, and they feel that the line agencies have already have a set of project plans to be proposed into the district budget.

The problems of transparency still persist in the bureaucracy of the district government. From the ten districts visited, community leaders in eight districts mentioned that there are issues with transparency in the district governments. The procurement practices of government projects have been identified as an area most prone to a lack of transparency. In some cases, the lack of transparency is identified to have affected the whole bureaucracy. However, there are some positive examples too. For instance, in two districts (Kab. Aceh Besar and Kab. Aceh Jaya) the community felt that there are signs of improvement in the transparency of the district government. In one

¹³² The results presented here are based on the sample of 10 *kabupatens* affected by tsunami, but are judged to be fairly representative of all Aceh province.

district (Kab. Aceh Jaya) the community has some confidence in the transparency of their district government.

Recommendations

The allocation of funds for general public administration needs to be scrutinized. The expansion of the government system and structures had a profound impact on the local governments' budget structure. It has resulted in a shift of expenditures from public service delivery towards general public administration. Despite the increased spending on public administration, the capacity of local governments remains weak.

It would be prudent for the provincial and national governments to prevent the creation of new *kabupatens*. The mushrooming of *kabupatens* seems to have had a negative impact on the capacity to manage budget funds. The creation of new *kabupatens* also results in dis-economies of scale, causing additional personnel, equipment and building costs, at the expense of investments in public services. Therefore, the process of screening of the establishment of new *kabupatens* needs to be made more transparent.

The top priority should be the capacity building of local governments. The main threat to the efficient use of public resources results from the lack of capacity for financial management and the lack of transparency and accountability. Given that the local government had invested heavily in general administration but with little positive impact, the capacity of local government must be enhanced, especially for planning and budgeting and transparency and accountability in order to improve the allocation of public funds.

Local governments could complete their regulatory frameworks to ensure that their resources are allocated strategically and in an accountable and transparent manner. Once the regulatory framework is in place, external audits could be used to ensure that local governments are accountable. Establish proper regulatory framework and mechanisms for participatory planning, accurate and timely accounting and reporting procedures and establish an independent and transparent monitoring and oversight mechanism should be set up and enforced.

Further investments in the administrative apparatus should clearly result in measurable improvements in efficiency. If the efficiency gains do not justify the investment, the resources should be shifted to public services. Returns on investing public funds in improving public services are likely to be greater than constructing new buildings for the general administration.

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ANNEX

Annex 1: Specific regulatory issues related to the budget process in Aceh

Issues Regulated in Qanun 4/2002

Apart from allocation of transfers, *Qanun 4/2002* also specifies about permanent secretarial office for fiscal balance section. The task of secretarial office is to provide input and data to the governor, which will be used for the policy formulation on the allocation of balancing fund.

The office is led by assistant of administration and general section from provincial secretarial office (Sekda). The head of permanent fiscal balance secretarial office is accountable to the governor through the secretary of provincial secretarial office.

Other Issues Regulated in Law 33/2004 (Not Covered in Law 18/2001 and Qanun 4/2002)

Law 33/2004 is the latest decentralization law that replaces the previous law 25/1999 on Fiscal Balance between Central and Regional Government. Topics that are covered in the law include the source of regional revenue, budget process and management in the context of decentralization, and Regional Financial Information System (SIKD). Some of these topics have been described in more detail in connection to the special autonomy in Aceh under Law 18/2001 and *Qanun 4/2002*. However, there are some topics in the Law 33/2004 related to regional financing issues that are not covered in Special Autonomy Law and *Qanun* related to regional financial issues, namely:

1. Regional Borrowing

Law 33/2004 opens the possibility for local government to borrow from domestic and international sources. Local government is allowed to borrow long-term funds to finance the development projects and short-term funds to handle the cash-flow problem.

Local government must get approval from local parliament in order to borrow from any domestic sources, while borrowing from international source cannot be done directly by the local government. Borrowing from foreign sources is done by the central government through the Ministry of Finance, which then by an agreement lends funds to local government.

2. Regional Financial Information System (SIKD)

SIKD is a facility provided by the central government through Ministry of Finance to collect, validate, process, and analyze regional financial information. Regional governments have the legal obligation to report this data to the Ministry of Finance in a timely manner. This information is an important input into policy formulation on the balancing fund, evaluation of regional fiscal performance, and national budget planning (RAPBN). It is also a key source for aggregate government financial statistics.

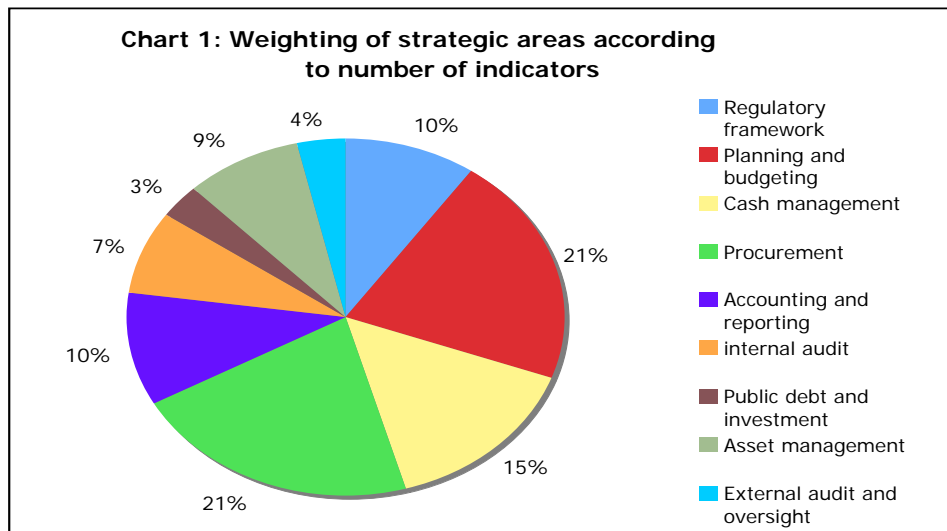
In 2003, there were 334 local government out of 370 total local government in Indonesia that have submitted their APBD report to the Ministry of Finance. According to Law 33/2004, central government can give sanction to local government that do not submit their budget by holding the transfer from the central to the region. In the case of Aceh, there are only 10 out of 20 local government that have submitted their APBD reports. However, further research needs to be done to find out whether there has been any measurement taken for those local government who do not submit their reports to the Ministry of Finance.

Annex 2: The PFM Framework: Strategic Areas, Outcomes and Indicators

The PFM framework was developed by the World Bank and Government of Indonesia's Ministry of Home Affairs to assess local governments' financial management capacity. The framework is divided into nine strategic areas key to effective management of public finances at district government: (1) Regulatory framework, (2) Planning and budgeting, (3) Cash management, (4) Procurement, (5) Accounting and reporting, (6) Internal audit, (7) Public debt and investment, (8) Asset management, (9) External audit and oversight.

Each strategic area is divided into between 1-5 outcomes and a list of indicators are provided for each outcome. The outcomes represent a desired achievement within each strategic area and indicators are used to assess to what extent a district government has achieved this. It should be noted that international best practices have not been used to form the basis of the outcomes as, in practice, the gulf between them and the present reality is too great to generate viable results.

Respondents are required to answer 'yes' or 'no' to each of the statements represented by each indicator. Affirmative responses are added for each outcomes and a score is calculated according to the percentage of 'yes' responses.. Some strategic areas have more indicators than others, hence, they have more weight in the overall results. For example, planning and budgeting covers 49 indicators, yet debt and public investment covers only 8. Other more heavily weighted strategic indicators include; procurement (41 indicators) and cash management (31 indicators).



Survey sites

For the first round of the implementation of the PFM framework, five locations were selected in Aceh province and two in Nias (an island forming part of the province of North Sumatra). The five in Aceh comprise: Banda Aceh (a city administrative unit) and the four districts of Aceh Besar, Aceh Jaya, Aceh Barat and Nagan Raya. The two districts in Nias island are Nias and Nias Selatan. All five sites in Aceh were badly affected by the earthquake and tsunami of 26 December 2004. Both districts in Nias were affected by the earthquake of 28 March 2005. LGSP-USAID already had a presence in the five sites in Aceh which could be used to help facilitate this first stage of the PFM implementation. These results are to be fed into the forthcoming APEA (World Bank) report in chapter 7: 'Improving local government's capacity, incentives and efficiency in managing budget

funds'. Future stages of the PFM implementation will cover the rest of the districts in Aceh and eventually will cover the rest of the country. The survey work will be done by World Bank, LGSP-USAID, and the Ministry of Home Affairs.

Methodology

Results were obtained through interviews and FGDs with local government representatives at the relevant departments. These include: The local planning agency (BAPPEDA, the finance department, the district parliament (DPRD), the local revenue department, the local treasury office and the regional monitoring agency. To ensure data accuracy 'yes' responses are required to be supported by either relevant documentation or/and cross-checked with additional respondents. Most results could be collected in two or three days.

During the two week period four field research teams implemented the PFM measurement framework in 6 districts and one city administration in Aceh and Nias. Most of the researchers are from well-regarded universities with a strong background in accounting and local finances. Each research team was coordinated by an LGSP-USAID facilitator. The University of North Sumatera provided researchers for the two sites in Nias, Hasanudin University provided researchers for Aceh Barat and Nagan Raya, Padang University provided researchers for Aceh Jaya and TARI institute and Syiah University in Aceh provided researchers for Banda Aceh and Aceh Besar. Peter Rooney from the World Bank joined the research teams in Aceh Barat, Nagan Raya, Nias and Nias Selatan. Andrew Urban (Local Government Finance Advisor, USAID) joined the team in Aceh Barat and Nagan Raya and Carlos Gavino (Local Government Program Advisor, USAID) joined the team in Nias. Each researcher contracted for the research followed a three-day training workshop conducted by LGSP-USAID prior to the field work. Prior to this several researchers had followed a training course conducted by Jessica Ludwig (World Bank).

Presentation of results

Results are listed for each of the 7 survey sites (6 districts plus one city administration). A score is given for each strategic area for each survey site and an overall score is given for each survey site. Also listed are the averages scores for each strategic area to enable show the relative weaknesses and strengths of a administration's financial management capacity. The results of the 5 Aceh sites and the 2 Nias sites have been separated so the average scores for each strategic area in Aceh are not influenced by the scores from the two Nias survey sites. However, for the two Nias sites an average score for strategic areas in all seven sites is shown. For the purposes of comparison and evaluation, strategic area scores can be graded according to the ranking categories shown in Table A.1.

Table A.1: Overall Ranking Guide

Overall Score (%)	
80-100	Excellent/Fully acceptable
60-79	Very Good/Substantially acceptable
40-59	Good/Fairly acceptable
20-39	Moderate/Partially acceptable
0-19	Poor/ Not acceptable