

Reclaiming Prosperity in Khyber-Pakhtunkhwa

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The citizens of Khyber Pakhtunkhwa (KP) continue to suffer a series of external shocks that have, over an extended period of time, significantly eroded living standards. However, recent developments in domestic and regional politics suggest that KP is on the cusp of reclaiming prosperity and a promising future. Withdrawal of NATO troops and political transition in Afghanistan present an opportunity to stabilize Afghanistan, which could in return, open up substantial regional trade and investment opportunities for Pakistan. Moreover, the current government, put in place following the May 2013 elections, has come in with a strong mandate to strengthen the province's economic and social foundation. Hence, KP's Economic Growth Strategy is a key instrument for fulfilling the elected government's mandate to improve citizens' living standards and creating opportunities for a prosperous future.

Growth Challenges

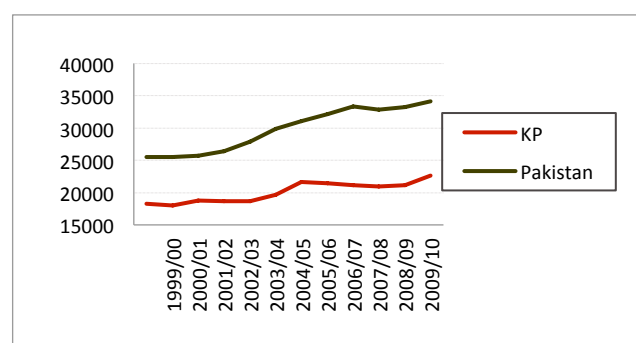
In the ten years up to 2011-12, KP's economy has grown at an annual rate of 4.2%, which is slightly lower than the national growth rate of 4.6% for the same period. (Figure 1.) This growth has been too slow to absorb the province's growing labor force and to have any substantial impact on living standards.

KP's economic growth thus needs to be stronger and inclusive, generating the required jobs

needed to raise living standards and reduce poverty and vulnerability. Importantly, inclusion requires that the growth strategy remove the causes of poor Millennium Development Goal (MDG) outcomes.

The starting point of the growth strategy is to set a realistically ambitious medium term economic growth target. The benchmark for this will be the federal government's projected national growth target of 7.5%¹. This target is to be achieved in the medium term, to match the increase in the size of the labor force. It will require a near doubling of total investment from 14% of GDP in 2013 to 26% in 2020. Much of this is expected to be private investment, projected to rise from 8.7% of GDP in 2013 to 19% in 2020.

Figure 1. Trends in Per Capita GDP, Pakistan and Khyber-Pakhtunkhwa



¹ Presented in the Vision 2025 document

Emerging Growth Drivers

While KP has suffered from several growth inhibitors, some important growth drivers have also emerged which, if properly harnessed, can propel the economy to a much higher growth trajectory. These include:

Urbanization

KP has seen periods of rapid growth in its urban population. High population densities along major road corridors have led to the development of urban clusters. While 83% of the province's population is classified as rural, over 2/3rds lives within a travel time of one hour from a city, and 90% lives within two hours. This has implications for the provision of government services and promotion of public and private infrastructure investments to develop the agglomerations, as hubs of economic activity and employment generation.

Regional Trade and Connectivity

KP has long enjoyed the advantage of being located at the apex of Pakistan's North-South economic corridor, linking Pakistan's economy, through the port of Karachi, to Afghanistan and beyond to Central Asia and China. Two developments are likely to have far reaching consequences for regional trade and its implications for KP's economy. One is the impending withdrawal of NATO troops from Afghanistan and the other is greater trade liberalization with India and the likely impact of that on transit trade through Peshawar and other trading posts along the Afghan border. KP's ability to reap the transformational benefits from international trade opportunities will depend on progress in three broad areas: (i) peace along its borders, (ii) trade facilitation through border ware-housing facilities, customs clearance and road and rail networks and (iii) improved competitiveness of priority growth sectors.

Remittances

In 2012-13, every fourth Pakistani who went abroad through the Bureau of Emigration & Overseas Employment or Protector of Emigrants, came from KP. This has had a large impact on KP economy. Sustaining this will require upgrading the skills of KP workers. While, the skill composition of other Asian workers in the Gulf, such as Indians and Sri Lankans, has changed due to a shift in demand, the composition of Pakistani and KP workers has not witnessed a shift towards higher skills. In light of the expected growth trends and structural changes in the Gulf Cooperation Council (GCC) countries, KP needs to: (i) gear up to the current and accelerated shift into higher paid jobs in services, including the fast growing tourist sector where large expansions are planned, and (ii) take advantage of major planned events such as the Dubai World Expo Trade Fair in 2020 and the soccer World Cup in 2022, which will provide more opportunities for higher skilled workers.

Increased Federal Fiscal Transfer

Provincial autonomy for managing provincial level economy has increased considerably following the 18th amendment to the Constitution in 2010. The devolved mandate is supported by the 7th National Finance Commission (NFC) Award, which has allocated greater financial resources to the provinces. This has raised KP's share in federal revenue, from about 7% of provincial GDP to 8.7% in 2009-10 and 11.3% in 2010-11. Federal transfers, proposed revenue measures and savings from spending efficiency will all contribute to expansion of the fiscal space, that will allow the KP's government to sharply increase both current and development spending in priority areas discussed below.

Priority Growth Sectors

Manufacturing and Construction

The recent performance of KP's manufacturing

which contributes to 17% of provincial GDP, has been mixed. Restoring manufacturing with a focus on cement, marble and granite finishing, pharmaceuticals and furniture and woodworking should be high priority in KP's growth strategy. Provision of steady energy supply and skills enhancement of the labor force is essential to achieve this. Without a strong manufacturing base, KP is unlikely to reap the full benefits of the emerging regional opportunities.

Construction (4% of KP's GDP) is another policy priority area. After agriculture, it is the largest employer of labor. Growth in the construction industry is largely correlated to growth in retail trade, which is a significant employer of low skilled workers. Retail trade has seen rapid expansion in the wake of consumption-led growth facilitated by remittances and slow-down in manufacturing. A modern, organized KP based construction sector would build on KP's comparative advantage in materials and could be the backbone of the construction industry in the country and beyond in the region.

Agriculture and Livestock

Agriculture (contributing to 14% of KP's GDP) provides direct and indirect livelihood to a majority of the rural population. However, despite the centrality of the sector, overall performance has remained poor. Farmers in the province are locked in low value crop production, such as wheat, due to lack of institutional support, fear of food shortage and inadequately developed markets. The decrease in land use intensity over the years and lack of expansion in irrigation (despite KP's many rivers) are contributing to the poor performance of agriculture. The horticulture sub-sector, on the other hand, has seen some progress in developing high quality fruit farms in recent years, but the success remains localized to a few areas. Measures needed to improve agriculture performance include (i) diversifying into high value crops, (ii) developing horticulture specialization, (iii) managing irrigation, (iv)

promoting certified seed nurseries and (v) strengthening agriculture research.

Livestock for meat and milk products is raised by millions of small and landless families in KP and contributes to 30% of the agriculture GDP. Despite KP being blessed with an ideal terrain and climate for livestock, herd size is small and yields remain low. KP government must invest in rangeland management, disease surveillance and prevention, develop a fodder policy and deregulate livestock markets. The private sector should be encouraged to invest in the various stages of livestock value chain including semen production, livestock medicines and slaughterhouses.

Mining²

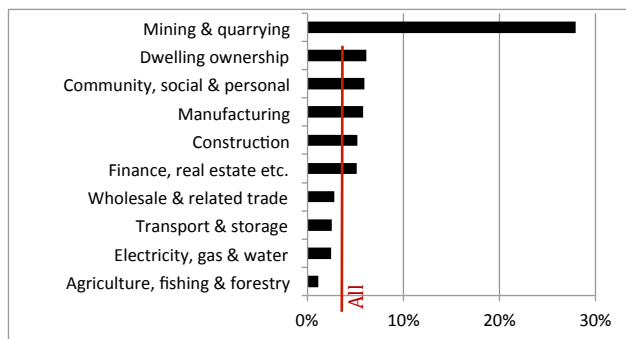
KP has vast reserves of minerals and gemstones. Hence, the mining sector has the potential to become a key driver of economic growth and has in fact witnessed strong growth during the last few years, contributing 3% value addition to the provincial GDP in 2012. Despite stellar performance in recent years, the sector suffers from a number of challenges. The most significant of which is the use of outdated technology that results in high wastage of minerals. Challenges are further exacerbated due to the lack of a comprehensive mining development framework (though work is underway on it). The regulatory regime in place for mining operations also has a number of loopholes. KP will benefit from a comprehensive mineral development framework that reviews mineral rights awarding procedures, creates a dispute resolution system, regulates the use of explosives, upgrades technology and rationalizes leasehold size.

² The discussion draws on "Assessing Baluchistan and KP Minerals Policy Framework", draft report, USAID FIRMS Project

Tourism³

Tourism in KP employs thousands of small and medium enterprises, covering locations with widespread poverty. According to estimates almost 8.8 million domestic tourists visit KP every year. This forms 19% of the total national domestic tourist traffic. Due to its geography, KP has a competitive edge over other provinces in tourism. Yet the tourism sector faces significant challenges such as poor law and order, dilapidated infrastructure and lack of an effective marketing strategy. This means that tourists are either discouraged by the absence of facilities or remain unaware of the potential sites to visit. Thus, key objectives of a proposed tourism policy are to establish KP as a preferred tourist destination nationally with an aim to increase tourist traffic by 10% annually over the next 5 years. With this, there is also a need to focus on setting quality standards, image building and infrastructure development.

Figure 2. Average Annual Growth 2000-2012



Investment Climate

Investment climate spans a range of factors that determine a destination's attractiveness for investors. The key determinants of competitiveness in KP are discussed below.

³ The discussion draws on, "Tourism Policy for Khyber-Pakhtunkhwa", draft report, USAID FIRMS project, October 2013

Cost of Doing Business

The World Bank's survey on the cost of doing business conducted in 2010 finds that Peshawar ranks 8th in overall ease of doing business, well behind the best performing Faisalabad. It is therefore, critical, to improve this ranking to make Peshawar an attractive destination for business.

Energy

Energy shortages remain a major impediment to attracting investment. Critical sources of inefficiency in the power sector are the large losses that occur in transmission and distribution. The provincial government has to engage effectively with the federal government to address the shortages arising from national constraints. At the same time, KP must exploit its considerable power generation potential by either setting up prospective power generation stations itself or through PPPs. Within thermal power, the government can focus on power generation through coal or bio fuel. For hydel power generation, small projects may be initiated in different parts of KP instead of large power generation units, which require large investments and more security measures.

Transport

The geographical location of KP, landlocked and being furthest from the seaport, makes the role of transport (that contributes to 13% of KP's GDP) critical in its economic progress. Road connectivity plays a critical role in the formation of industrial clusters, which in turn results in agglomeration economies, attracting more businesses. Linking economically backward areas to economic hubs within and outside KP will provide access to employment, education and healthcare for the relatively low-income districts. Road and rail connectivity will be critical for KP to realize the benefits of regional trade.

Rule of Law

KP and FATA have both been challenged by the specter of worsening conflict during the past decade. In addition, the province also faces

challenges of growing litigation and weak contract and regulatory enforcement, which become important pre-conditions for slow growth and low employment creation in the province. Therefore, rule of law and governance reforms need to be a central pillar of KP's Growth Strategy. There is an urgent need to institute a Police and Prosecution Reform Committee, which can frame a modern sentencing law and work in coordination with the Local Government Department to propose a framework for strengthening linkages between the formal justice system, the local government system and informal dispute resolution mechanisms. There is also a need to invest in a forensic science laboratory in KP along with the establishment of a Command and Control System (with first responder capacity) and Crime Scene Units in the capital city.

E-governance⁴

E-governance initiatives can play a key role in bridging the information gap for citizens. There is a need to restructure the provincial Information Department for better management of modern communication tools leading to more effective governance. Moreover, establishing an ICT-based Complaint Redressal System for KP is also imperative. Automating government systems such as procurement processes, public college admissions, crime investigation, land records, and birth certificates will further help improve efficiency.

Inclusion

Healthy, educated and better skilled workers are the most critical interventions for inclusive growth.

⁴ This discussion is based on Khyber Pakhtunkhwa growth chapter as reflected in the federal government's Vision 2025 paper.

Health and Education

A sound health and education sector is key to ensuring that KP meets its MDG targets and has a productive labor force to sustain long-term growth. In the health sector, problems of low immunization coverage, stagnant infant and maternal mortality rates as well as low quality of curative healthcare, need to be addressed. In education, significant gaps persist between access and outcomes across regions, gender and income with low learning outcomes. Measures to overcome these challenges include:

- Scaling up the existing models of Public-Private Partnerships in the education sector
- Use of ICTs in monitoring of health and education facilities
- Implementing Conditional Cash Transfer programs to enhance access to education and health services
- Restructuring vaccination programs
- Expanding the engagement on Basic Health Units
- Launching special programs for identification, training and development of female teachers
- Targeting female education and maternal health
- Upgrading existing primary schools to middle level to improve transition rates
- Supporting high quality and low cost private schools

Skills Development

KP is passing through a demographic transition that is creating a 'youth bulge'. Realizing the dividends of the demographic transition will require addressing critical challenges related to human capital development and the labor market. It will require building skills sets that enable citizens to increased benefit from the province's tradition of migration. This will be fundamental in restoring livelihoods and generating employment in the province, in the conflict zones and in FATA. Furthermore, an

important challenge in KP is to enable a transition away from low-end vulnerable employment that accounts for 3/4^{ths} of non-farm jobs in the province. There is also massive underinvestment in skills provision by the public and private sectors. Thus the Growth Strategy supports the KP government's target of increasing recurrent and development expenditures for the sector by 50% over the next three years. For this to be effective, the increase in budget has to be accompanied by the formulation of a provincial Skills Policy.

Fiscal Space

The improvement in fiscal space following the 2010 constitutional amendment (and the supporting NFC award) and agreement on hydel profit needs to be consolidated with specific measures to improve public expenditure management and tax revenue collection.

Expenditure Management⁵

In terms of efficiency, large pay and pension raises in the last two fiscal years have consumed significant public expenditure, which has compromised spending on operation and maintenance, with adverse consequences for asset maintenance. Furthermore expenditure management has not fostered linkages of inputs to outputs. Artificial bifurcation of current and development expenditure budgets has increased compartmentalization of budget formulation, undermining efficiencies of a more integrated budget making. Measures to address these include (i) developing a well-designed debt-management strategy, (ii) introducing professional pension fund management, (iii) establishing a balance between development and current expenditures and (iv) strengthening project design of new schemes.

⁵ This discussion draws on, World Bank (2013), "Pakistan - Khyber Pakhtunkhwa: Public Expenditure Review". Washington, DC.

The Consortium for Development Policy Research (CDPR) is an umbrella organization that provides a platform for research centers, local academic institutions and think tanks to promote evidence-based policy-making. It aims to bring latest research findings on important policy issues to policy makers, media, citizens and political parties. CDPR is funded by the International Growth Centre.

Revenue Mobilization

The high growth targets set by the KP growth strategy have implications for the province's revenue mobilization. Assuming that KP sets the same growth and investment targets as the federal government's national targets⁶, it is estimated that KP's total expenditure will rise from PKR 327 billion in 2014 to PKR 389 billion in 2015 and PKR 826 billion in 2020, even with conservative projections of current expenditure relative to its growth in the recent past. A substantial revenue effort by the government of KP will hence be required to increase the provincial tax-to-Provincial GDP ratio by 0.1% per year from FY2014/15 till FY2019/20.⁷ Since KP's share in provincial tax revenue in FY2013/14 was 5.8%, we assume that this percentage will remain unchanged in the forecast period.

The major sources of tax revenue for KP in 2014 were: (1) land revenue (Rs. 1300 million), (2) GST on services (Rs. 8000 million), (3) motor and vehicle tax (Rs. 1075 million), (4) stamp duty (Rs. 670 million) and (5) electricity duty (Rs. 507 million). However, each of these sources of revenue has to be made more buoyant, requiring far reaching policy and institutional reform.

⁶ Federal government's Vision 2025 sets average GDP growth at 4.3% in 2013-15 and 6.79% in 2015-20.

⁷ The assumptions underlying these tax simulations are in line with the federal government's medium term budgetary framework but conservative compared with the recommendation in *Pakistan: Finding the Path to Job-Enhancing Growth*, World Bank Report No. 75521-PK, Washington D.C. 2013.