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Reclaiming Prosperity in Khyber-Pakhtunkhwa

A Medium Term Strategy for Inclusive Growth

Executive Summary of Full Report

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International Growth Centre, Pakistan Program

The International Growth Centre (IGC) aims to promote sustainable growth in developing countries by providing demand-led policy advice informed by frontier research. Based at the London School of Economics and in partnership with Oxford University, the IGC is initiated and funded by DFID. The IGC has 15 country programs.

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Executive Summary

The citizens of Khyber Pakhtunkhwa have suffered a series of external shocks over an extended period of time that has eroded living standards. These include the fall-out from over three decades of the Afghan conflict, spill-over of the militancy in FATA, devastation caused by the 2005 earthquake, internal displacement of 3 million people following the conflict in Swat in 2009, and the damage inflicted by unprecedented floods in 2010. The fact that KP's political governance structure has consolidated, financial flows led by remittances have strengthened and the economy has grown at 4.5% per annum in this period, underscores the resilience of KP citizens and the social and economic structures that shape their lives.

Recent developments in domestic and regional politics suggest that KP is on the cusp of reclaiming prosperity and a promising future. The withdrawal of NATO troops and the political transition in Afghanistan present an opportunity for a fresh start for stabilizing Afghanistan. Dialogue with FATA militants has opened the door to a potentially constructive engagement in the border regions. These developments could open substantial regional trade and investment opportunities. Importantly, the elections of May 2013 have put in place a government with a strong mandate to build on the province's economic and social foundation.

KP's economic growth strategy, summarized here, is a key instrument for fulfilling the elected government's mandate to improve citizens' living standards and creating opportunities for a promising future.

Growth Challenges

In the ten years up to 2011-12, KP's economy grew at an annual rate of 4.2%, slightly lower than the national growth rate of 4.6% in the same period. Growth, moreover, was highly volatile given the external shocks. Even though KP's growth in the more recent period of 2008-2012 was slightly higher than the national average, at just above 4% per annum, it is too slow to absorb the increase in KP labor force.

Currently, at 37%, labor force participation in KP is the lowest of all provinces (the national average is 46%) and the unemployment rate, at 9%, the highest (national average is 6%). Thus a major challenge in KP is that economic growth be high enough and inclusive enough to increase the provincial labor force participation rate and provide productive employment to the fresh entrants.

The most recent Millennium Development Goals (MDG) outcomes for KP do not show an encouraging trend on inclusion. The proportion of population below the poverty line in KP at 39% is substantially higher than the national average. Net primary enrolment ratio at 53% is lower than Punjab's 67% as is the literacy rate (52% compared to Punjab's 60%) and substantially below MDG targets. Similarly, contraception, maternal mortality and infant mortality rates are also far below the respective MDG targets. KP is also off target on many indicators of gender equality. The objective of inclusion requires that the growth strategy removes the causes of such poor MDG outcomes.

The starting point of the growth strategy is to set a realistically ambitious medium term economic growth target. The benchmark for this is the federal government's projected national growth target of 7.5% to be achieved in the medium term to match the increase in labor force growth (presented in the Vision 2025 document). This 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, which is projected to rise from 8.7% of GDP in 2013 to 19% in 2020.

Matching federal government's national growth and investment targets will mean that going forward KP's citizens will enjoy the same income level as the average Pakistani (in 2013, the average income in KP was 10% lower than the average Pakistani's). Economic growth and living standards in KP could be significantly higher than the national average if the benefits of regional trade are fully realized including making the transition from a trading hub to a manufacturing hub as outlined below.

KP's economic growth, moreover, has to be inclusive generating the needed jobs to continue to improve poverty outcomes. The ultimate goal is to reduce poverty to a single digit, concentrated in hard to reach areas and among the transitionally poor for which targeted cash grant programmes, such as the Benazir Income Support Programme (BISP), can be used as an effective tool.

Emerging Growth Drivers

While KP has suffered from several growth inhibiters, some important growth drivers have also emerged which, if properly harnessed, can propel the economy to a much higher growth trajectory. The salient ones discussed in this report include the ongoing urbanization in Peshawar valley and Hazara and the untapped potential of regional trade. KP also receives a large share of the rising remittances to the country that could, with improved financial intermediation, be a large pool of private investment. The recent substantial increase in fiscal transfers by the federal government, following the 18th amendment of the Constitution and the agreement on hydel profits, can facilitate larger public investments to attract private investment and entrepreneurial talent to the province.

Urbanization

KP has seen periods of rapid growth in its urban population, in part due to the influx of refugees from Afghanistan during the 1980s and the 2000s, and displacements caused by floods and conflict in the last decades. It is estimated that in 2013 Mardan, Charsada and Swabi districts all have a population density exceeding 1,000 persons/sq. km, and Peshawar a density of 2,716 persons/sq. km.

While 83% of the province's population is classified as rural, over two-thirds of the population of the province lives within a travel time of one hour from a city, and 90% of the population of the province lives within two hours.[1]City populations in KP have extended outside the administrative boundaries of the municipalities and "ribbons" of development along the highways have evolved, largely due to accessibility to transport links, availability of skills and services as well as tax and tariff incentives. Even in more rural areas, the highest population densities are along the major road corridors enabling easier access by these rural areas to services in the cities and towns. This has resulted in the emergence of three clearly identifiable urban agglomerations:

- *Central Pakhtunkhwa:* The districts of Peshawar, Charsada, Mardan, Swabi and Nowshera. These districts cover almost 10% of the area of the province and contain 36% of the population concentrated in and around the four cities of Peshawar, Charsada, Nowshera and Mardan.
- *Hazara:* The districts of Haripur, Abbottabad and Mansehra, with an area of 11% of the province, contain 15% of the provincial population (estimated at be 3.16 million in and around the city of Abbottabadand and in medium and small towns of the area– Mansehra, Haripur, Havelian and Khalabat.
- *Others*: Three relatively smaller but significant concentrations of population are in the districts of Swat with 7% of the provincial population, Dera Ismail Khan with 5% and Kohat with 3%.

It is estimated that these agglomerations account for nearly a third of the provinces area and two-thirds of the population. The development of these urban clusters have implications for the provision of services by the government and promotion of public/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 the port of Karachi and Pakistan's economy to Afghanistan and beyond to Central Asia and China. Afghanistan and Pakistan are natural trading partners with complementarities in trade in goods and services. Karachi port facilitates a significant share of Afghanistan's foreign trade. Since 2000-01, Pakistan's exports to Afghanistan increased from

[1] 7% of the population lives within a travel time of 2-4 hours from a city. The remaining 2% of the population that lives at a travel time of more than four hours from a city are all residents of Chitral district.

US$ 100 million to US$2.4 billion in 2010-11 spanning a range of products including agricultural commodities, cement, pharmaceuticals, leather and footwear, machinery and household products. There is also substantial export of services (health education, IT etc.) with potential for significant increase. KP benefits from much of this trade and, if positioned well, stands to gain much more.

Two developments are likely to have far reaching consequences for regional trade and its implications for KP's economy. These are the impending withdrawal of NATO troops from Afghanistan and the other is the granting of MFN status to India and the likely impact of that on transit trade through Peshawar and other trading posts along the Afghan border. Peshawar valley, emerging as a major cluster of economic activity (see above), could again play its historical role of a cultural and commercial hub for a vast region stretching from Central Asia to India. Indeed, the prosperity for KP from cross border engagement could be on an unprecedented scale given that it would be the connector of the economies of India, China and Central Asia that are poised to grow at rates never seen before.

KP's ability to reap the transformational benefits from international trade opportunities depends on progress in three broad areas: <u>Border related issues</u> which include peace in the border areas of KP and Baluchistan and cross-border trade and transit agreements; <u>trade facilitation</u> that includes border ware-housing facilities, customs clearance etc. but also road and rail networks that facilitate the flow of goods and services between borders with Central Asia, India and China, and port cities on the Arabian sea; and <u>competitiveness</u> of priority growth sectors via improvement in investment climate, reduction in the cost of doing business, more skilled workers and more efficient intermediation of remittances and other financial flows (discussed below and in Chapters 2-5). Progress in policy and institutional dimensions in these areas will transform KP from a trading hub to a manufacturing hub for the region unleashing the innate entrepreneurial talent of KP citizens for sustained high economic growth and improvement in living standards.

<u>Remittances</u>

In 2012-13, Pakistan received an estimated USD 13 billion as workers' remittances through formal (banking) channels—almost 60% of its total export earnings and over 5% of its GDP. A full quarter of these workers—in other words, every fourth Pakistani who went abroad through the BEOE or Protector of Emigrants—comes from KP. The stock of KP workers among total overseas Pakistanis is calculated as between 1.2 and 1.7 million.

Most migrants from KP end up in the Middle East, where unskilled workers are the dominant category. The proportion of unskilled and skilled workers leaving the country from 2004 to 2012 ranged from 41% to 50% and 28% to 36% respectively. While the earlier phase of development in the GCC countries was dominated by construction activities, the skill mix has changed over time. New sectors have emerged, of which services has become the major sector. In the current occupational distribution of citizens and foreigners for the latest available years in three countries—Bahrain, Kuwait, and Saudi Arabia— the largest category of foreign workers is in sales and services: almost 42%, followed by professional and technical categories at 12%. The share of services in total employment has increased in recent years and is expected to go up further as these countries diversify their pattern of economic growth. The skill composition of other Asian workers, such as Indians, has changed due to this shift in demand; the composition of Pakistani workers, however, has not witnessed a shift towards more skilled workers.

In light of the expected growth trends and structural changes in the GCC countries, KP needs to: (i) gear up to the current and accelerated shift into higher paid jobs in services, including in the fast growing tourist sector such as hotels, shopping malls, and airport and airline services in which large expansions are planned, and to build on the current major occupation in these countries as drivers and unskilled workers 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.

There are two areas where KP government can play a role in maximising the development benefits of overseas migration:

First, overseas migration falls under the purview of the federal government and a separate ministry/division handles this subject, including supervising a number of agencies and organisations that have been set up to regulate, monitor and support overseas migration. The provincial government needs to work closely with these organisations. There is little evidence to suggest that this is actually happening, and an exercise needs to be carried out urgently to develop a strategy on how to take full advantage of the resources being spent by the federal government on these organisations, and to get them to work effectively and in close collaboration with the respective provincial bodies and organisations.

Second, education and skills training is a provincial subject and it is primarily in this area that we strongly recommend that the KP government takes into account the existing and projected demand for skills and professions abroad in formulating its educational plans and training programmes and policies. The principal aim of such policies must be to move the current profile of migrants from KP into higher and better paid skills and professions abroad.

Third, there is a need to improve the investment climate in the province (elaborated below) to convert remittances into productive investment.

Increased federal fiscal transfers

Provinces' autonomy for managing their economy has increased considerably following the 18th amendment to the Constitution in 2010. Many subjects that were previously in the mandate of the federal government have been devolved to the provinces. The devolved mandate is supported by the 7th National Finance Commission (NFC) Award that allocates greater financial resources to the provinces. Additional revenue from the federal government has also resulted from the transfer of 1% of the undivided divisible pool as compensation against war on terror and the payment of arrears by the Federal Government hydro-electric profits. This has raised the province's share of federal revenue sharply, from about 7 of provincial GDP to 8.7% in 2009-10 and 11.3% in 2010-11. As a result, KP realized an increase in fiscal space between 2006-07 and 2010-11 of 3.5% of provincial GDP over the previous five years[2]. Three channels—federal transfers, proposed revenue measures (see below) and savings from spending efficiency—have contributed/will contribute to the expansion of fiscal space, that allows the provincial government to sharply increase both current and development spending in the priority areas discussed below.

Priority growth sectors

Manufacturing and Construction

The recent performance of KP's manufacturing (17% of KP's GDP), which produces a range of products, is mixed. It grew strongly between 2003 and 2008 but declined thereafter mainly because of the difficulties faced by large firms. The slow-down is attributed to both the energy crisis but also to deterioration in law and order. Because manufacturing activity requires multiple contracts along a long supply chain, it is highly sensitive to deterioration in law and order because contracts are harder to enforce. Restoring manufacturing (with a focus on cement, marble and granite finishing, pharmaceuticals and furniture and woodworking) has to be high priority in KP's growth strategy. This is because manufacturing activity creates jobs for a broad spectrum of skills and has the potential to deliver well-paying jobs for many decades. 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 workers. It is strongly correlated with growth in retail trade (a significant employer of low skilled workers), which has seen rapid expansion to cater to consumption-led growth facilitated by remittances and slow-down in manufacturing. A comprehensive construction sector strategy needs to be developed that focuses on both construction materials, the sector's skills and financing requirements as well as construction standards. 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.

Manufacturing and construction sectors will benefit significantly from the removal of cross-sectoral hurdles that increase the cost of doing business. Discussed in Chapter 4 are issues pertaining to energy, transport and rule of law. The sectors' need for educated and skilled workers is discussed in Chapter 5 on inclusive growth.

Agriculture and Livestock

[2] World Bank (2013), "Pakistan - Khyber Pakhtunkhwa : Public Expenditure Review". Washington, DC.

Agriculture (14% of KP's GDP) is a large contributor to the economy of KP, providing direct and indirect livelihood to a majority of the rural population. However, despite the centrality of the sector, the overall performance in terms of growth 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 lack of developed markets. The decrease in land use intensity over the years and lack of expansion in irrigation (despite KP's many rivers) is further deteriorating the sector's performance. The horticulture sub-sector has seen some progress in developing high quality fruit farms in recent years but the success remains localized to a few areas. The measures needed to improve agriculture performance include:

- *Diversifying into High Value Crops*: Given comparative advantage and rich potential, KP needs to diversify into high value maize from the current focus on wheat. For food security, wheat could be procured from Punjab. Private companies, like Rafhan, Pioneer, Monsanto, etc. could be encouraged to start an exchange programme of wheat with maize supported by the provision of modern inputs, especially seed and fertilizer.
- *Developing Horticulture Specialization*: Agro-clusters, replicating the successful experiences of growing high quality peach in Swat, should be developed.
- *Managing*: The province needs to benefit from abundance of rivers by increasing canal irrigation. There is also a need to provide incentives to the farmers for replacement of flood irrigation with high efficiency irrigation systems.
- *Promoting certified seed nurseries*: To promote certified nurseries, government has to establish mother blocks of original fruits and vegetable varieties from where true-to-type material can be distributed to certified nurseries. Financial support will be required to set up laboratories and green houses for nurseries in the private sector.
- *Strengthening agriculture Research*: KP can adapt the successful experience of Punjab Agricultural Research Board (PARB), which is responsible for research planning and prioritization, and coordination between research institutes in the public and private sector within the country and abroad to promote modern technologies and systems.
- *Agriculture Extension:* The current extension services system lacks modern capacity and is not functioning to support a commercially viable sector. The private sector's capability to provide extension services to farmers along the entire value chain needs to be explored and developed.

Livestock for meat and milk products is raised by millions of small and landless families in the province with an estimated value of 30% of agriculture GDP. Livestock herd size is small and yields are low despite KP being blessed with an ideal terrain and climate for livestock. Following KP's local government Act, 2012, the provincial government is fully empowered to frame all rules for modernizing the sector. It needs to invest in rangeland management, disease surveillance and prevention, developing a fodder policy and deregulation of livestock markets. The private sector should be encouraged to invest in various stages of livestock value chain including semen production, livestock medicines and slaughter-houses.

Mining[3]

KP is blessed with vast reserves of minerals and gemstones. The mining sector has the potential to be a key driver of economic growth and has witnessed strong growth during the last few years, contributing 3% value addition to the provincial GDP in 2012. The provincial government also gets direct revenue from leasing out the mines, which further underscores the significance of this sector.

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 wastage of minerals. The size of investment required to operationalize a mine is the key factor in the use of technology. At present very little large-scale investments are being made in the mining sector resulting in lost opportunity to maximize the returns from mineral resources. The 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 has a number of loopholes that result in a lost opportunity to benefit the maximum out of this natural resource.

The province will benefit from a comprehensive mineral development framework that clarifies institutional arrangements; modernizes laws and regulations; establishes a predictable minerals fiscal regime; and protects workers, the environment and the society. The specific measures include:

- *Review of mineral rights awarding procedures*: There is considerable discretion in the award of mineral rights, with only 5% of licenses being actually evaluated by the licensing department. A review of these and putting together regulatory oversight mechanisms will drive away low quality mining operations by reducing the discretion that may be benefiting private parties.
- *Creation of a dispute resolution system*: In KP there is significant reliance on the use of the provincial court system to resolve most of the cases; this results in project delays and negative perception of mining in the province. For attracting investment this regulatory gap must be addressed.
- *Regulating the use of explosives:* Existing regulatory mechanisms are not working properly to curb the use of explosives in mining operations. This is probably due to the deficiencies in enforcement but also due to lack of empowered inspectors and meaningful penalty schemes.
- *Technology up-gradation*: The government has already eliminated all tax on the import of mining equipment. However, the lack of easy financing options makes it difficult for miners to procure such machines. The government should provide loans on easy installments or zero interest rates to help finance the procurement of proper equipment. Alternatively the government can facilitate the establishment of equipment rental market.

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

- *Rationalize leasehold size:* Sections of mines remain unexploited because of the limited capital available to mine leaseholders. Production can be enhanced by reducing the mine area directly under the control of the lease holder, allowing the investor to focus his/her funds to a smaller area and providing opportunities for new investors to enter the area.

Tourism[4]:

Tourism is considered to be a key source of poverty reduction and inclusive economic growth in poor countries. Tourism employs a large share of unskilled or semi-skilled workers, including youth and women. In KP tourism employs thousands of small and medium enterprises and covers locations with widespread poverty. Estimates suggest that the total number of domestic tourists visiting KP in a year is about 8.8 million, which is 19% of total national domestic tourist traffic. Geography has endowed KP with a competitive edge over other provinces in tourism.

However the tourism sector faces a number of challenges:

- *Law and order:* The poor law and order situation due to armed conflict in KP has taken a toll on the tourism sector, while the security crisis in Swat and other tourist areas have caused unprecedented damage.
- *Dilapidated and destroyed infrastructure:* Infrastructure loss and dilapidation due to recent armed conflict and natural disasters such as floods has affected the availability of tourist facilities in KP.
- *Lack of a marketing strategy:* There is lack of an effective and well-coordinated marketing strategy to promote Pakistan and particularly KP as a preferred tourism destination.
- *Workforce constraints:* There are only a few degree courses on tourism offered by large universities in KP. The only notable training institute in KP for tourism and hospitality-related training has been non-operational since the conflict in Swat.

The key objectives of a tourism policy will be to establish KP as a preferred tourist destination nationally with an aim to increase tourist traffic by 10% annually over the next 5 years. The following reforms can be carried out with an estimated investment of PKR 50 billion.

- *Tourism and allied Infrastructure Development:* Rehabilitate existing facilities and infrastructure, but also seek new opportunities for development, such as improving or building access roads to tourist towns and attraction places.
- *Quality assurance and standards:* Introduce standards and a quality regime for hotels, restaurants, tour operators, travel agencies and other tourism service providers.
- *Provide incentives to increase investment in tourism:* Provide land on long lease at subsidized rates for tourism projects in less developed areas; fast track clearance for investments to such projects that are above PKR 100 million; attract foreign investors for larger projects such as chairlift/cable car resorts, four and five star hotels/adventure activity

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

centers and recreational parks etc. Introduce a law on public private partnerships (PPPs) to facilitate the private sector to invest in tourism.

- *Marketing and image-building:* Develop a multi-pronged branding strategy; promote and develop PPPs for tourism marketing and joint branding campaigns; involve PIA and Pakistan Railways for an integrated role in tourism promotion; promote cultural and sports events such as Shandur Polo Festival and Kalash Festival.
- *Develop a tourism workforce:* strengthen and upgrade curriculum and training facilities including PAITHOM.
- *Active Implementation*: Create a tourism development committee to spearhead implementation. The committee shall nominate tourism reform leaders for each of the strategic areas; these will be provincial legislators and will ensure removal of hurdles in implementation

Investment Climate

Investment climate spans a range of factors that determine a destination's attractiveness for investors such as the cost of interface with the government as a regulator, availability of reliable energy and transport, the legal environment for contract enforcement etc. These key determinants of competitiveness are discussed in this section.

Cost of doing business

The World Bank's survey on the cost of doing business includes the time it takes and costs incurred to meet government regulations for starting a business, dealing with construction permits, registering a property, paying taxes, trading across borders and enforcing contracts. The survey conducted in 2010 finds that Peshawar ranks 8^{th} in overall ease of doing business well behind the best performing Faisalabad. It is critical therefore to improve this ranking to make Peshawar an attractive destination for business.

The key areas for improvement are:

- reduce the number of days for starting a business by developing online processes
- streamline procedures for construction permits and registering property
- simplify procedures for paying taxes and reduce the number of taxes
- make it easier to trade across borders through better facilitation (dry ports etc.)
- reduce the time and money cost of contract enforcement

Energy

Energy shortages are a major reason for the poor performance of KP's manufacturing. The government of KP has to engage effectively with the federal government to address the shortages arising from national constraints. At the same time, KP can develop its own considerable hydro-electric potential.

The total number of consumers under Peshawar Electric Supply Company (PESCO) has increased by approximately 3.5% over the past five years to 2.78 million. This is accompanied by a gradual rise in consumption by small, medium and large industries, reflecting a positive trend in the provincial economy. KP also has significant potential for power generation. Due to its terrain the province has a strong comparative advantage for hydel power generation; with a potential of generating 27,000 MW electricity of the 40,000 MW available in all of Pakistan. The province has also seen increased activity by nonprofit organizations such as AKRSP and SRSP in taking forward micro-hydel initiatives. Paktunkhwa Hydel Development Organization has already identified five big sites with a total capacity of 5000 MW and 67 small hydel sites with a total capacity of 400 MW.

A critical source of inefficiency in the power sector is the large magnitude of losses that occur at the transmission and distribution stages. These losses are both technical (due to physical components of the power system such as transmission lines or transformers) and non-technical (external to the power system such pilferage, non-payment, defective meters, errors in accounting etc.) The severe gap between the supply and demand for electricity has taken a significant toll on KP's economic growth and KP must exploit its power generation potential to address the power shortfall by either setting up power generation stations by itself or through PPPs. Within thermal power, the government can focus on power generation through in short to medium run using gas from the provincial quote. 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. Micro hydel power generation has also got potential, but success rates have been slower mainly due to issues with sustainability.

Measures to improve the energy situation include:

- *Increased provincial stake in PESCO***:** PESCO, a federal government entity, relies significantly on assistance offered by the provincial government for its operations. To bridge lapses in cooperation, it is recommended that the KP government acquire control of PESCO at selected sub-divisional level to increase bill recovery against guaranteed power supply, a model already tried by PESCO.
- *Bifurcation of PESCO:* PESCO may be bifurcated by setting up of another independent company on the basis of geography, or consumers' mix; this would improve the performance and efficiency of the two companies.
- *Attract investment:* There is a need to launch investment roadshows to draw private investors, through equity and debt, who can easily finance the construction of dams and earn a sizeable return on investment.
- *Encourage micro hydel power generation***:** the government should a) carry out a proper geological survey at UC-level to find out the overall potential available for micro hydropower projects b) encourage financial institutions to facilitate micro-hydel power based projects by delivering small business loans on easy terms and conditions for local business groups c) build link roads to ensure access to difficult sites d) reduce taxes or custom duty on all the imported machinery that is used in micro hydropower projects e)

ensure that implementing agencies have in-house capacity to design and implement the project

Transport

The geographical location of KP, landlocked and being furthest from the sea-port, makes the role of transport (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. This creates a virtuous cycle benefiting the economy in three ways: (1) pooling of labor with the required skill-sets; (2) reduction in the cost of transportation; and (3) technological diffusion due to the exchange of ideas. In KP, industrial density is the highest in the central districts and Swat, and high road density and/or proximity to national highways is positively correlated with the number of industrial units. 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. The link between transport infrastructure and poverty alleviation in Pakistan is supported by empirical evidence.

Road and rail connectivity will be critical for realizing the benefits of regional trade for KP.

Despite the historical significance of transport and connectivity in the KP economy, the growth of the road networks and related infrastructure is far below that in Punjab. For districts having similar population density in the two provinces, the road density (km of road per sq. km of land area) in Punjab districts is higher than that in KP districts. There was also a sharp decrease in KP's road network in the year 2010-11 due to massive floods affecting 24 districts and resulting in a loss 6,511 kilometers of road network.

Industrial and economic disparity within KP is also a consequence of geography (elevation and terrain), which impedes infrastructure development. The regions of Kohistan, Battagram, Shangla, Hangu, Karak and Tank are the least industrialized districts with relatively low road density and lack of access to highways.

Since most economic activity is concentrated in the central region of KP, the aim of transport infrastructure should be to improve the connectivity of economic clusters in the center with the less developed regions of KP. This will lead to increased economic activity and creation of employment and income across KP.

- *Connecting relatively poor areas to economic hubs:* Investment in road networks is required in Kohistan, Battagram, Shangla, Hangu, Karak and Tank to better connect these regions to the rest of the province and the country. This will open up the relatively remote and economically depressed areas and facilitate inter and intra-provincial flow of goods, local investment and labour.
- *Continued maintenance of existing road network***:** In the absence of an extensive railway service, roads and highways are heavily used for passenger and freight traffic. To mitigate the resultant deterioration of road and transport infrastructure, the existing network needs

to be improved with special emphasis on transport infrastructure up-gradation and maintenance. Existing projects to repair and rehabilitate the road network damaged in the 2010 floods need to be expedited towards completion, to recover the lost connectivity of the affected areas.

- *Mass Public Transit system for Peshawar***:** Mass transit system (MTS) for Peshawar is one of the major projects planned by the government. It includes the establishment of a bus rapid transit system in combination with a rail-based system. This will facilitate commuters by providing them with a safer, faster and convenient mode of transport.
- *Completion of existing and planned initiatives:* The government should also focus on completing existing initiatives on the regulatory and reform side as well as those dealing with infrastructure. This includes the following: i) Establishing and strengthening of a Transport Regulatory Authority that will take over some critical regulatory functions of the Transport Department; ii) Construction of trucking terminals at Peshawar and Dera Ismail Khan, to serve as focal points for trucks and containers and assist the government to better regulate the trucking industry.

Rule of Law

The KP province and FATA have been challenged by the specter of worsening conflict during the past decade. In addition, the province is faced with challenges of growing litigation and weak contract and regulatory enforcement. These are 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.

The justice gap (the offenses brought to justice rate) in KP's criminal justice system is high. This is due to challenges related to the quality of police investigations; in particular evidentiary challenges related to the lack of forensic evidence and absence of witnesses; the lack of established processes, guidelines and standard operating procedures; and poor cooperation framework between police and prosecution. It is also adversely impacted by a weak, nascent and fragmented prosecution function that is based on a weak legal framework that has not ensured a transition to a truly autonomous and independent prosecution service. At the level of the courts, the justice gap is impacted by delays in litigation, growing case pendency and inconsistent sentencing. These problems are worsened by low barriers to entry for new cases and appeals and low costs for frivolous litigation and delays.

Weak contract is the result of a civil justice system with weak pre-trial disclosures, low costs for frivolous litigation and delays and an antiquated legal framework. Providing access to justice for the indigent and marginalized is a continuing challenge for the justice sector in KP. Finally, the absence of a comprehensive framework that builds linkages between formal informal justice systems that have a great presence, traction and popular appeal in KP is both a challenge and an opportunity.

There is an urgent need to institute a Police and Prosecution Reform Committee headed by senior members of cabinet, members of the KP legislature and other relevant stakeholders that propose implementable reforms that build on the Police Order 2002. The Reform Committee should also suggest reforms to the Police Rules 1934 and propose a legal framework that institutionalizes an independent and autonomous prosecution service. It should also frame a holistic crime prevention policy that consolidates and coordinates the divergent legal and regulatory frameworks for provision of security and information gathering. It should 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 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. Police rules need to be revised to institutionalize modern protocols of securing and preserving scenes of crime and chain of custody protocols. These efforts need to be complemented by programmes that train officers in modern investigation techniques and the institutionalization of framework for witness protection that becomes the basis of a law and programme in this area. Adequate budgetary provisions need to be provided to enable the institutionalization of a modern investigation and prosecution system.

There is also a need to establish an effective case and docket management system at the level of courts that is integrated with the policing and prosecution system. There is also a need to introduce a performance management pilot for the Capital City Police and prosecution along with an independent case review board. Finally, it is important to design an evaluation model of legal aid and scale-up the more successful designs.

E-governance[5]

E-governance initiatives can play a key role in bridging the information gap for citizens. The following measures are proposed to strengthen e-governance:

- Restructure the Provincial Information Department to better manage modern communication tools for more effective governance
- Set up an autonomous and empowered Provincial IT Board
- Establish an ICT-based Complaint Redressal System for the Province
- Computerize government records and the process of issuing vital documents for citizens
- Automate government systems such as: procurement processes, public college admissions, crime investigation, land records, and birth certificates etc.

The Right to Information Act 2013 complements the e-governance initiative. This Act enables citizens' access to information in all public matters. It covers all public sector institutions of the province including subordinate judiciary and the provincial assembly.

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

Under the legislation, web-based e-publication and maintenance of official records/information of all public bodies is mandatory. The law provides for a sound enforcement mechanism in the form of an independent "Information Commission".

Inclusive Growth

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

Health and education

With more resources available, following the most recent NFC award, the provincial government has an opportunity to increase education and health expenditures and also improve the efficiency of spending[6].A sound health and education sector will be the key to ensuring that KP meets its MDG targets and has a productive labor force to sustain long-term growth.

Continuing conflict and a deteriorating security environment has had disastrous effects on both health and education. The preventive health sector is plagued by problems of low immunization coverage (particularly in Hazara and Southern KP), stagnant infant and maternal mortality rates and low quality of curative healthcare with significant regional and gender disparities. KP has also failed to control polio despite using all the available resources. Curative health care is marred by problems of access and quality that are often ranked below national averages.

In education, significant gaps persist between access and outcomes across regions, gender and income. Dropout rates are high while transition rates remain abysmally low. Literacy figures are also substantially behind the national average. Access is constrained by both economic and cultural factors as well as by limited schooling inputs. Due to the floods in 2010 and subsequent years, thousands of children have been put out of school, with displaced families often remaining unable to send their children to school.

Specific measures for health include:

- *Management of the health system:* To reduce the burden on provincial and district health departments the government should expand the engagement on Basic Health Units with Peoples Primary Health Initiative (PPHI) to remaining districts. Rural Health Centers and Tehsil hospitals should be handed over to local governments with the authority to outsource the management of these hospitals on the model of PPHI.

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

- *Monitoring and supervision of health service providers:* The Punjab Government has experimented with using smartphones to improve monitoring of health facilities by making the senior health officers of the districts accountable[7]. A similar system can be pilot tested and adapted to the needs of the health department in KP.
- *Improve vaccination coverage:* Since there is huge variance in vaccine coverage across different regions of KP it is important to have a localized communication strategy. Government should set aside a specialized unit along with necessary resources for running the polio campaigns and let the EPI cells focus only on routine immunization.
- *Explore public private partnerships:* A specialized ambulance or transport system should be started in partnership with the private sector that can shuttle the patients between hospitals for a minimum user fee. The government can also provide some subsidy on per patient basis to reduce the burden on poor families.
- *Tie healthcare to social protection:* The provincial government should form partnership with BISP to identify the families that can benefit from the transfer of additional cash if the vaccination and maternal health conditions are met and expand "waseela-e-sehat" health insurance programme in the province.

On education, measures include:

- *Focus on Primary Education*: KP needs to re-evaluate its policy of higher levels of investment in secondary and tertiary subsectors. Primary education should be the focus of provincial investments to improve enrollment rates and learning outcomes.
- *Enhance Female Enrolment:* One key intervention that the government can make is to increase the number of female teachers, since this hugely increases parents' confidence with respect to sending their daughters to school. Girls' access to school is still limited by safety concerns. Schools should therefore be built in those areas where they do not exist in order to reduce travelling time.
- *Improve Monitoring:* Emphasize monitoring performance in the education sector by giving increased importance to the Education Management Information System (EMIS) so that the school infrastructure conditions can be appropriately reflected.
- *Tie education to Social Protection:* By linking social protection programmes such as the Benazir Income Support Programme with school attendance levels and increasing the amounts provided for education, their impact could be enhanced.
- *School mapping:* School Mapping should be done to ensure that enough schools are present in far-flung and remote areas and not just concentrated in certain regions. This will ensure accessibility.
- *Improve transition rates:* Upgrade existing primary schools in all provinces to middle level so that children have opportunities to transit from primary to middle and then to secondary levels of education.
- *Education provision in emergencies:* Provision of education in emergencies, particularly

[7]Michael Callen, Saad Gulzar, Ali Hasanain and Yasir Khan. 2013. "Political Economy of Public Employee Absence" IGC Working paper

floods, must become a core part of any education policy/strategy of the government of KP.

- *Target deprived districts:* It is important the resources over the next 5 to 10 years are spent in higher proportions in the most deprived districts. This will help reduce the stark disparities in the education sector.

Skills Development

KP is passing through a demographic transition that is creating a “youth bulge”, which provides a one-time window for stimulating growth. However, this may turn into a disaster if the young are not productively employed. Realizing the dividends of the demographic transition will require addressing critical challenges related to human capital development, jobs and the labor market. It will require building skills sets that enable citizens to benefit from the province’s tradition of migration. Since a large proportion of the young have poor educational attainment, skill development is the most important pathway for human capital accumulation for the citizens of KP. In the case of KP this pathway will be fundamental in restoring livelihoods and generating employment in the province, in the conflict zones and in FATA.

The supply-side of KP’s labor market is severely constrained with labor force participation being 22% lower than the national average. This challenge is particularly severe among young males (15-25 years) and women, and is adversely impacting growth. The low participation rates reflect unemployment rates that are higher than the national average. An important challenge is to enable a transition away from low-end vulnerable employment that accounts for three-fourths of non-farm jobs in the province.

Massive underinvestment in skills provision by the public and private sectors is a critical challenge in the skills market, which forecloses human capital accumulation opportunities for young adults. This is coupled with the absence of a provincial skills policy and an institutional framework for ensuring coordination, quality of content and delivery, relevance, demand-responsiveness, industry-linkages and certification. Finally, the challenge is to integrate demand-side interventions, such as stipends and programmes with on-job components, which make skills training attractive for potential trainees from marginalized and poor households.

The Growth Strategy Report supports the KP government’s target of increasing recurrent and development expenditures for the sector by 50% over the next three years. However, to be effective the increase in budget has to be accompanied by the formulation of a provincial Skills Policy and the formation of a high level Policy and Advisory Committee with representation from a key members of Cabinet, the business community, leading and supporting departments, skills experts and private providers. The Committee must align skills initiatives with growth priorities, set medium to long-term targets and monitor progress on the agenda. It must be given the task of coordinating provincial, donor and federal skills programmes and strengthening industry linkages. It should also ensure linkages between skills initiatives and programmes to augment jobs and catalyze self-employment. The Committee must also make a case for the institutionalization of a national accreditation system that ensures quality of training.

An immediate initiative is to improve institutional governance in the public sector by reviving idle capacity, setting clearly defined performance standards and monitoring performance of outcomes and outputs through third parties. Corporatizing KP-TEVTA and inducting private sector management is an important component of this task. This initiative should be complemented by the institutionalization of a Skills Development Fund with the objective of seeding quality supply by incentivizing the private sector to contribute to the supply of training. The Fund should adopt competitive bidding with an output-based payment system linked with outsourced monitoring. The Fund should also support demand-side interventions (for example, stipends) that enable access for marginalized populations. It should also incentivize providers to complement skills training with on-job components and job placement services. The Fund should have FATA and conflict-zones as an important focus. In the case of FATA the skills response has to be part of a programme to stimulate the earnings of migrant labor and tied to local clusters and be placed in a rehabilitation strategy integrated with education, counseling and family participation.

These initiatives need to be supported by the establishment of research capacity in the government that provides context-specific evidence on skills shortages and gaps in the province. Since KP is an important source of export of manpower, research may be commissioned to assess skills gaps in national and international sectors that engage labor from the province. This will ensure that the skills development plan is demand responsive.

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.

Expenditure Management[8]

Measures to promote efficiency in health and education sectors were discussed in the previous section. More broadly, large pay and pension raises in the last two fiscal years have consumed significant public expenditure, which has compromised spending on operation and maintenance (a decline by 2% to 8% of expenditures in 2010-11 from previous year), with adverse consequences for assets maintenance. Another weakness pointed out by World Bank's Public Expenditure Review is that expenditure management does not foster linkages of inputs to outputs. Artificial bifurcation of current and development expenditure budgets increases

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

compartmentalization of budget formulation, undermining efficiencies of a more integrated budget making. Measures to address these include:

- Develop a well-designed debt-management strategy. Given the borrowing powers conferred to provinces in 18th Amendment, KP may consider revisiting its debt recording and management system in collaboration with the EAD at the federal level.
- Given the large expected pension liability, KP may consider improving pension fund management, which would help reduce the claim on the budget of pension payments.
- Fully implement output-based budget allocation for all new schemes. This will move away from the current practice of artificially splitting current and development budget allocation. It should start by initiating a process of consultative agreement between the Finance Department, Planning & Development department and the line department to achieve measurable output indicators.
- Improve effectiveness of public expenditure by improving the balance between development and O&M expenditure.
- Revise "release procedures" to ensure smooth implementation of the budget. It may be appropriate to adapt the federal government's "New System of Financial Control and Budgeting" to streamline releases for recurrent and development budgets.
- Strengthen project design of new schemes by empowering Planning & Development department so that no new large activity can be budgeted for implementation without an approved feasibility study.

Revenue Mobilization

The high growth targets set by the KP growth strategy have implications for revenue mobilization by the province. A well-designed growth strategy, that aims at private sector led growth and creates the right environment for PPP in public investment, can help reduce the fiscal burden of financing growth but not eliminate it altogether.

Assuming that KP sets the same growth and investment targets as the federal government's national targets[9], this report estimates that KP's total expenditure will rise from PKR 327billion in 2014 to PKR 389billion in 2015 and PKR 826billion in 2020 even with conservative projections of current expenditure relative to its growth in the recent past. Federal transfer from the divisible pool and hydel profits will help meet some of the needed increase in expenditure but

[9] An annual average growth rate of 6.79% GDP between 2015-16 and 2019-2010 is projected in Government of Pakistan, Pakistan: Vision 2025 (Discussion Draft), Planning Commission, December 22, 2013. Total investment is projected to double from 12.6% in 2013 to nearly 24% in 2020. Private investment is expected to constitute the bulk of the investment needs and is projected to rise from 8.7% of GDP in 2013 to 16.2 in 2015 and 19% in 2020.

will not be enough even with optimistic projections of tax-to-GDP ratio.[10] A substantial revenue effort by the government of KP will be required to increase the provincial tax-to-PGDP ratio from the current 0.47% to about 0.8%. This will have to be translated into concrete measures.

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

Tax on services, which until recently was being collected by the federal government on behalf of the provinces, is now being collected by three of the four provinces through provincial revenue authorities. The collection efficiency of sales tax on goods is low by international standards but collection of sales tax on services is still only a fraction of the collection efficiency of sales tax on goods. The growth in revenue achieved by Sindh and Punjab in sales tax collection suggests that KP can also expect to raise considerably larger revenue from this source in the next few years. The services sector in 2010-11 was estimated to be 58.5% of the provincial GDP. If a value added tax at the rate of 16% is applied to all services, the potential tax revenue was PKR 249 billion in 2013-14. The current tax collection is effectively targeting only 3.2% of the full potential.

Agricultural land and incomes are taxable under the NWFP Land Tax and Agricultural Income Tax (Amendment) Ordinance 2001. The tax rates on agricultural land have remained frozen at the 2000 level and that of the income tax at the 2001 level. The NWFP Land Tax and Agricultural Income Tax (Amendment) Ordinance 2001 allows the taxation of agricultural incomes but it also allows for tax to be collected as a land tax if the tax assessed as Agricultural Income Tax (AIT) is less than the tax calculated as land tax. However, the tax is collected largely as a land tax. The tax rates have not been revised for many years and tax collection is miniscule.

Changing the current form of tax collection from a land tax to an income tax will require building a modern income tax machinery. This could take a number of years but in the interim, land tax rates could be revised in a way that the tax collection from land (as a proxy for income tax) is comparable with income tax collection in other sectors of the economy. These measures will not only hold an important symbolic value in terms of fairness and equity but will also add another PKR2 billion to the provincial government finances, which is over 19% of the provincial government’s budgeted tax revenue in 2013-14.

Revenue from Urban Immovable Property Tax (UIPT) in KP in 2013-14 was PKR 108million. This is 0.85% of provincial tax revenues. To achieve international benchmark, tax revenue from UIPT in KP must increase from its present level of PKR 108million to about PKR 13 billion at 2013-14 prices. To reach the level in Punjab (Pakistan), UIPT must increase to over PKR 1 billion or over 9 times the present level of collection in KP. This will require:

[10] The tax-to-GDP ratio (excluding provincial taxes) is projected to increase by 0.8% per year every year till 2018, taking the ratio from its level of 8.9% in 2013 to 12.9% in 2018 and then remain unchanged at that level.

- Separating valuation from rate setting; the former is a technical matter and the latter a political decision. The valuation tables, which report tax liability per unit of property and are implicitly a product of property value and tax rate, should distinguish between the tax base and the tax rate.
- Developing a system of periodic revaluation of properties.
- Broad basing the tax by eliminating tax exemptions, taxing vacant plots and removing tax preference for owner-occupiers.
- Allowing natural growth in the property tax base by indexing the tax rate to the rate of inflation.
- Upgrading the skills and size of the staff that assess and collect UIPT.
- Decentralizing property tax policy and administration to local governments.

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