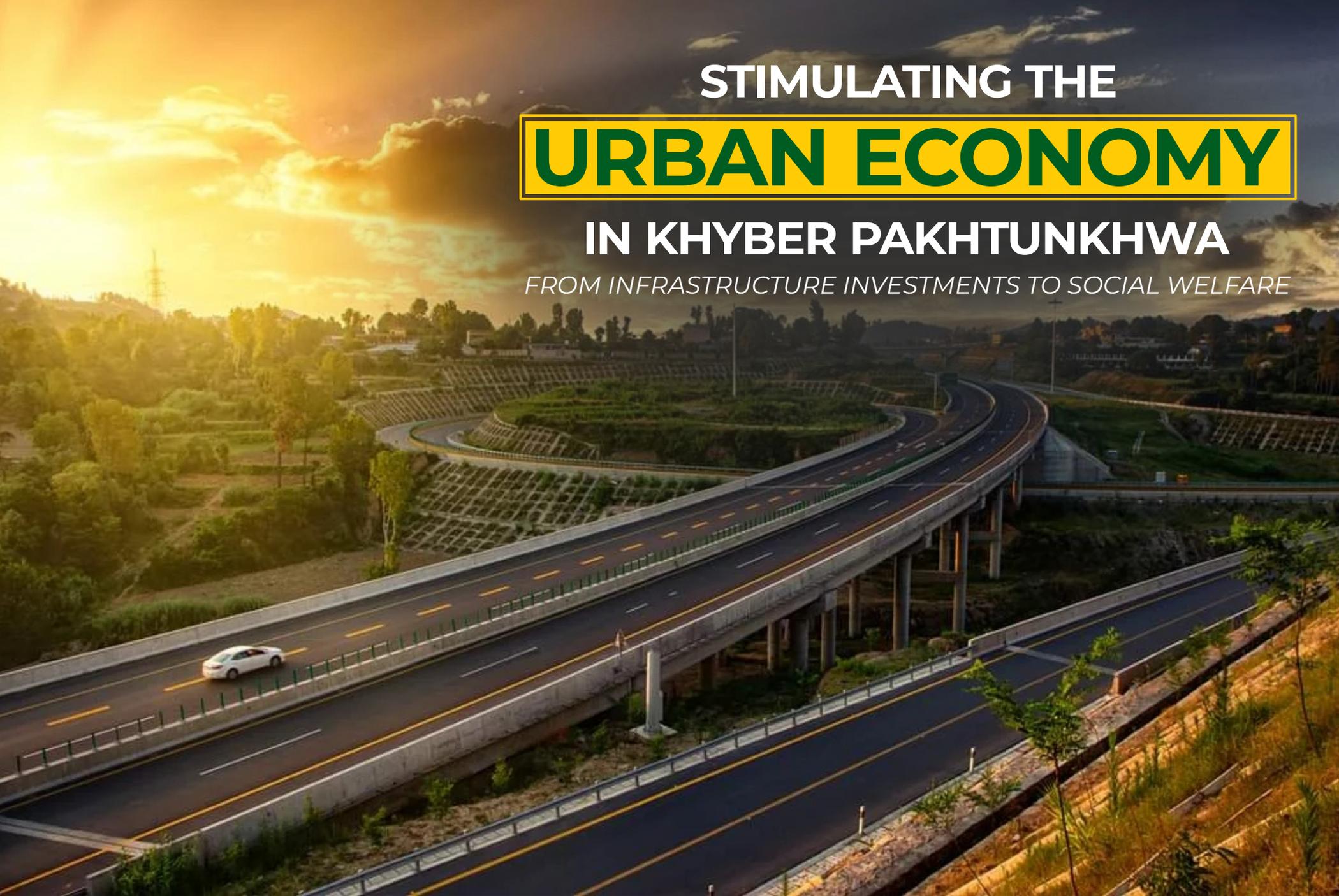


STIMULATING THE **URBAN ECONOMY**

IN KHYBER PAKHTUNKHWA

FROM INFRASTRUCTURE INVESTMENTS TO SOCIAL WELFARE



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This report was authored by Dr. Ammar A. Malik (Harvard Kennedy School) with research assistance from Sibtay Hasan. Key input was provided by Hina Shaikh (International Growth Centre) and Zara Salman (Consortium for Development Policy Research). The report benefited from contributions from Dr. Ijaz Nabi (Consortium for Development Policy Research) and Victoria Delbridge (Cities at Work Initiative at the IGC).

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The team would like to thank the Urban Policy Unit (UPU), Government of Khyber Pakhtunkhwa, for their continued support throughout the development of the note.

MESSAGE FROM

Mr. Shahab Ali Shah

*Additional Chief Secretary
Government of Khyber Pakhtunkhwa*



The Government of Khyber Pakhtunkhwa recognizes urbanization as a key driver of economic growth for the province. While the bulk of our population still resides in rural areas, cities are growing quickly, with the potential to drive innovation, create jobs, raise revenue for the Government and become hubs for commerce and trade. To fully realize this potential, urban growth needs to be planned in a way that aligns with the strategic social and economic objectives of the Government.

These objectives have been clearly captured in the Sustainable Development Strategy 2019-23. The Strategy seeks to improve the delivery of municipal services to accommodate growing demand in urban areas. Spatial planning must be streamlined with effective and business-friendly land-use regulation. The private sector must be engaged to play its role as businesses,

investors, lenders, and taxpayers. Civil society must be involved to represent the interests of vulnerable communities fully. But most importantly, the Government must put in place policy measures to stimulate urban economic growth and job creation.

This Policy Note makes a number of promising recommendations in this regard. It highlights critical challenges that hold back economic growth in Khyber-Pakhtunkhwa's cities and towns and suggests solutions based on sound evidence and analysis. One key strategic concern raised by the Note is the need for greater complementarity between mega projects being launched under the China-Pakistan Economic Corridor and improvements in urban infrastructure, services, and the availability of skilled labor force in urban centers. Without simultaneous investments in

the urban economy, large-scale projects focusing on regional connectivity will not realize their intended benefits for the province.

This carries important implications for the Government's policy agenda, not only for urban development but also for our strategic economic vision for Khyber-Pakhtunkhwa. I commend the work carried out by the Urban Policy and Planning Unit and the Sustainable Energy and Economic Development (SEED) programme and look forward to future Policy Notes planned in this series.

MESSAGE FROM

Mr. Adeel Shah

*Executive Director, Urban Policy and Planning Unit
Government of Khyber-Pakhtunkhwa*



The Urban Policy and Planning Unit (UPPU) was established in 2012 to respond to emerging urban policy and planning challenges for Khyber-Pakhtunkhwa (KP). Since then, the Unit has provided the Government with a range of technical inputs to guide public investment and broader economic planning for the province, specifically: land-use planning, transport, WASH, urban governance, informal housing, among other areas.

This series of Policy Notes and Webinars that the Unit is conducting with support from the Sustainable Energy and Economic Development (SEED) programme, is an opportunity to take a multisectoral, multidisciplinary approach to urban development problems in Khyber-Pakhtunkhwa that builds on the latest available data captured by advanced technology and tools. This Note builds on independent

research, night lights data captured through satellite imagery, and official statistics to create a comprehensive demographic and economic profile of KP's urban settlements, noting changes in key variables over time and projecting future trends.

This analysis was then presented in a webinar attended by several national and international experts on urban development. This provided an opportunity to learn from urban innovations, policy successes, and lessons from within and outside of Pakistan, which helped enrich the Note and broaden the mix of ideas it captured.

The Note makes several recommendations where the Urban Policy and Planning Unit can play a leading role. For instance, the UPPU can technically support the development of local

economic development plans in collaboration with local government actors; liaise with relevant stakeholders to roll out land-use plans and develop regulations to ensure their implementation; or develop plans for urban infrastructure investments to complement CPEC projects such as Special Economic Zones.

I'm excited to be a part of this initiative and look forward to collaborating with SEED to work on future Policy Notes and take the essential steps to implement the policy recommendations and insights emerging from this process.

MESSAGE FROM

Mr. Hasaan Khawar

*Team Leader
Sustainable Energy and Economic Development
(SEED) Programme*



Improved urban planning is one of the key results sought by the Sustainable Energy and Economic Development (SEED) programme. Khyber-Pakhtunkhwa has urbanized at a slower pace than Punjab and Sindh. Still, statistics indicate that going forward, the bulk of national rural-to-urban migration and urban agglomeration will happen in this province. This represents a significant opportunity to enhance and capitalize on KP cities' contribution to improving national productivity and growth. Urban investment – from public and private sources – will need to be expanded and made more efficient to make this happen. KP will also need to improve urban governance, finance, service delivery and move its cities to a higher growth trajectory.

The Government of Khyber-Pakhtunkhwa (GoKP) is fully conscious of these challenges

and has taken several steps to address them. Strategic policies and plans– such as the Sustainable Development Strategy 2019-23 – place urban development at the center stage and commit the government to specific development priorities and initiatives under this rubric. SEED has aligned itself with GoKP priorities and is currently providing technical support for raising public investment efficiency in economic and urban sectors across the province. This would boost the productivity of urban capital assets and help increase the coverage and quality of urban public services.

This Policy Note series is essentially an opportunity to think and strategize broadly about urban policy and planning in KP. The initiative seeks to bring onboard world-class expertise on urban policy issues, learn from current, global thinking and practice in this domain and

analyze existing data to produce policy solutions that meet the needs and expectations of the GoKP.

The Planning and Development Department (PandDD) and Urban Policy and Planning Unit (UPPU) have attached the highest priority to this initiative and have collaborated closely with the SEED team to define the scope and focus of this Note and succeeding Notes in this series. We hope it adds value to the current policy discourse on the issue and informs GoKP urban policy. Going forward, we stand ready to support the UPPU and other GoKP agencies in implementing the recommendations emerging from this Note.

KEY MESSAGES OF THE POLITY NOTES

- KP's economic policy strategy focuses on **large infrastructure investments** and improved social welfare outcomes for the **underprivileged**.
- The path from **industrialization to prosperity** goes through the route of well-functioning cities that work for residents and businesses alike.
- There are considerable variations across districts and divisions within KP on key indicators of human development and on relative **levels of urbanization**.
- Factors that slow down economic growth in urban centers include **inefficient land-use**, lack of basic services and infrastructure, untapped trade potential and **massive spatial disparities**.
- Broader **economic development** objectives can be achieved through:
 - Complementary policies accompanying infrastructure investments to enhance local business productivity.
 - Creating a singular focus across all levels of government on economic development policies through administrative restructuring.
 - Creating and implementing plans for improved public service delivery and land use by empowering urban local governments to lead the way in.
 - Prioritizing a localized trade and sectoral focus for urban centers.

EXECUTIVE SUMMARY

Buoyed by an improved security situation in recent years, the government of Khyber Pakhtunkhwa (KP) is pursuing an economic strategy focused on two key priorities. First, large-scale infrastructure investments in highways, powerplants and special economic zones with funding from various Chinese entities as part of the China Pakistan Economic Corridor (CPEC). Second, strong focus on social protection services, particularly in health and education, intended for the uplift of the lowest-income segment of society.

Provincial growth and development hinges on KP's cities. The pathway from infrastructure investments to improved social welfare passes through KP's urban areas, which must emerge as the engines of economic growth enabling productivity improvements through innovation that will also create new jobs. Unless KP's cities can offer adequate amenities and social and economic opportunities for all residents, particularly its youth and women, long-term development objectives simply cannot be achieved.

The province stands at a structural disadvantage in this regard. KP is the least urbanized province in Pakistan and is urbanizing slower than the national average. Urbanization is also highly uneven – Peshawar for instance is urbanizing at 45%, while most of the newly merged districts do not appear to have seen any urbanization at all. This creates wide geographical disparities in population density, economic growth, availability of skilled labor, industrialization and adequacy of municipal services. In addition, the urban economy appears inhospitable to women workers and entrepreneurs – even more so than in rural areas. Female labor force participation in KP's cities is weighed down by lack of security in public spaces, limited women-friendly transportation options and greater time burdens due to greater care responsibilities in the absence of traditional social ties.

A number of policy challenges must be resolved for KP's cities to become engines of growth. First, urban land-use patterns are inefficient. High-value inner-city land parcels are underutilized while urban sprawl is

encroaching into increasingly scarce agricultural farmland. Only 2% of KP's land mass has built-up settlements. A quarter of the land area is used for agriculture while the vast majority of land – 73% is unsuitable for cultivation. Under supplied housing demand has encouraged the development of residential areas outside cities, while reducing space for open spaces, green spaces and recreational areas, affecting livability.

Second, the quality and coverage of basic services are below expectation. For instance, piped water reaches less than half of KP's urban population for limited durations and sewage waste generated by 85% of this population flows into open drains. Third, trading markets are operating sub-optimally. Rural-urban economic integration is poor. Under investment in customs trade facilitation and the absence of supporting industries and services has limited the trade potential of KP, despite its strategic location and the large volume of transit trade flowing through the province.

There are a number of policy interventions that can address these challenges despite the structural weaknesses affecting KP's urban economy. First, CPEC mega projects need complementary local investments to ensure long-term productivity improvements. Unless local businesses adopt new technologies and management practices by learning from international companies and becoming part of their international value chains, the full benefits of physical infrastructure developments cannot be achieved. In KP, this will require deep reforms for creating robust economic institutions that would provide an improved business climate for international corporations, supporting ecosystem for budding local entrepreneurs and equality of opportunity for all societal groups. Furthermore, with coordination and enablement from provincial agencies like the Board of Investment or the Urban Policy and Planning Unit, cities must produce their own local economic strategies based on unique competitive advantages that complement large-scale investments underway.

Second, improve policy coordination between local, provincial and federal

authorities. Given that infrastructure investments like Special Economic Zones and highways represent spatial bets in carefully identified locations, economic policymakers at all levels must be fully coordinated and clearly understand their specific role in the overall development strategy. Hybrid governance systems must be created to supplement the existing structure around administrative boundaries of districts, tehsils and village councils with fully empowered multi-level functional delivery units around economic development strategy.

Third, restore and empower elected local governments. City leaders' functional responsibilities around service delivery must match their authority over running service delivery units, setting service fees and raising their own capital for major investments. In turn, they must be held accountable by the communities they serve through new performance frameworks including ample opportunities for participation in budgeting. Women's particular service delivery needs such as locations of bus stops or design of buses must be systematically incorporated into all development projects through their active participation in the planning, budgeting and implementation of new projects.

Lastly, planning for economic development, industrialization and trade should be localized. Government must provide localized sector support to urban centers by identifying competitive and growing industries, particularly where they are positioned to capitalize on the comparative advantages and providing support for these industries through the range of mechanisms at the disposal of local and provincial governments. The advantage of such a proactive approach is that cities can focus on providing an enabling business ecosystem for industrial growth, by targeting specific economic sectors for economic development initiatives. Moreover, Peshawar can also reclaim its role as a hub of regional trade and as a commercial center to become a major growth node in the country. KP can benefit immensely from trade links with India, China and Central Asia by playing its natural role as a connector with the potential rents accruing to KP that can be later invested in building a strong manufacturing and export base for the future.

KEY RECOMMENDATIONS

Policy Interventions

Complementary Urban Investments to Benefit from Megaprojects

Enhance the benefits of agglomeration by investing in improvement of service delivery and skills development

Policy Direction

1. Improve urban livability through public service delivery
2. Supply a skilled workforce to fill growing job demand
3. Improve the business climate

Specific Initiatives

For instance, the economic benefits from the Rashakai SEZ could be broadened to the local economy and sustained over time by:

1. Introducing programs for local workforce development in line with expected demands from industry
2. Reviewing land-use regulations to facilitate new housing construction
3. Upgrading service delivery units to effectively meet expected demands on services such as water and sanitation

Policy Interventions

Develop New Policy Coordination Mechanisms Across Federal, Provincial and Local Tiers

Create singular focus across all levels of government on economic development policies

Policy Direction

1. Government interventions to improve development outcomes should be aligned to the economic potential of each district
2. To achieve the development objectives, municipal finance must be strengthened to generate revenue
3. Local economic planning must be improved by strengthening local governance

Specific Initiatives

1. Give Tehsils with large shares of non-agricultural workers 'urban' status under the Local Government Act to make them eligible for urban development funding and technical assistance
2. Improve inter-district coordination around mega projects through new mechanisms e.g. a Greater Peshawar Valley Authority for Rashakai SEZ
3. Strengthen UPU-KP as a technical arm to enhance local economic development planning

Policy Interventions

Improving Service Delivery and Land-Use Planning via Local Governments

Truly empower urban elected local governments to undertake decisions around local economic development planning and public service provision

Policy Direction

1. Undertaking smaller steps within local government jurisdiction in close coordination with provincial and federal agencies to improve service delivery
2. Contribute to master planning of cities and SEZs

Specific Initiatives

1. Strengthen fiscal position of local governments, for instance, by allowing Tehsil governments to set rates, levy and collect the Urban Immoveable Property Tax as empowered by the Local Government Act
2. Strengthen social compact and quality of service position, for instance, by introducing participatory budgeting (first piloted in Porto Allegre, Brazil) to allow local citizens influence over local public spending.
3. Improve land use policies by finalizing and adopting land-use plans being developed by the Urban Policy and Planning Unit

Policy Interventions

Developing Identity of Cities as Hubs of Economic Activity and Trade

Help urban centers define their economic identity to inform economic planning and investment decisions

Policy Direction

1. Reclaim Peshawar's role as a hub of regional trade and as a commercial center to become a major growth node in the country.
2. Focus on trade links with India, China and Central Asia by playing KP's natural role as a connector with the potential rents accruing to the province that can be later invested in building a strong manufacturing and export base for the future.

Specific Initiatives

1. Define a city's economic identity, for instance, through tourism projects which leverage private investment through PPPs
2. Make economic planning a function of local government with assistance from a central hub such as the UPU-KP in collaboration with local business forums
3. Improve trade facilitation by building on transit trade to Central Asia with added services such as dry fruit processing, cleaning and packaging.

INTRODUCTION

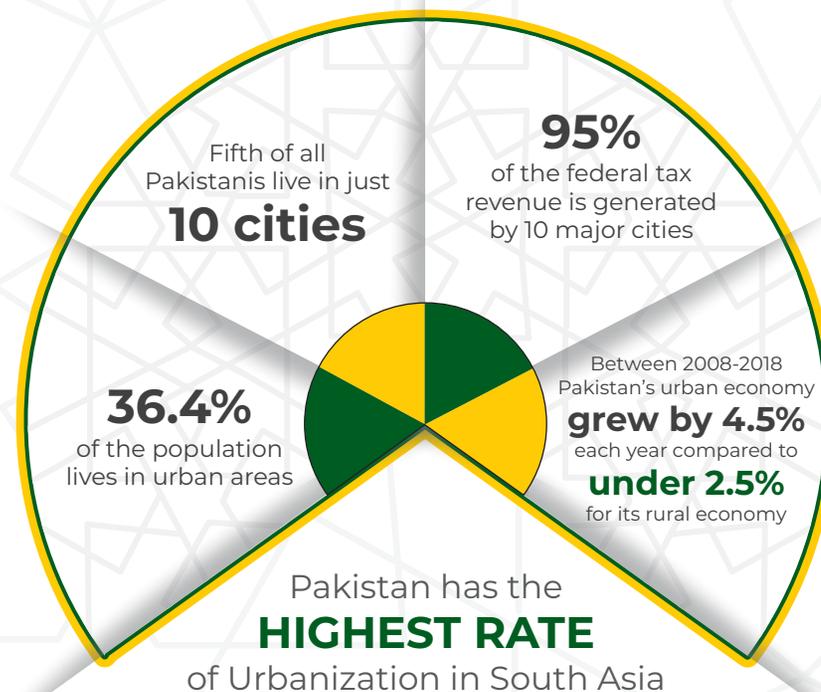
- 1.1 Role of Cities in Shaping Economic Growth
- 1.2 About this Policy Note
 - 1.2.1 Motivation
 - 1.2.2 Key Objectives

KEY MESSAGES

- # 01
- When urbanization works, the economy expands faster as more people inhabit cities. Cities can be hubs of innovation and entrepreneurship. Cities can create economies of scale. Cities can create jobs. Urbanization can positively impact technological innovation.
 - If done right, urbanization can be transformative for Pakistan. Globally, cities generate about 80% of the GDP. Cities in Pakistan generate 55% of the GDP. KP, in the past, has constituted around 10% of the national GDP. Cities in KP generate over 70% of the provincial GDP.
 - But the relationship between urbanization and growth is not automatic. Urbanization can occur without growth, jobs and productivity. Unplanned urbanization can lead to urban slums, environmental degradation, poverty and inequality.
 - This policy note underlines a framework to think about stimulating KP's urban economies premised on building an understanding of the urban landscape, existing bottlenecks and their underlying causes, expected drivers of economic change and direction for policy reform.

1.1

ROLE OF CITIES IN SHAPING ECONOMIC GROWTH



Pakistan is the fastest urbanizing country in South Asia. This urbanization can be transformative for Pakistan as international experience shows that effective cities can become economic hubs and globally competitive drivers of growth.

When urbanization works, the economy expands faster as more people inhabit cities and urban areas can become important drivers of growth. A higher concentration of people in cities grows the economy and boosts innovation. Cities can become the key arena for innovation that drives long-term productivity improvements. Denser economic activities can create economies of scale. When firms cluster

together, formation of local value chains is also encouraged. Besides offering density of population for robust exchange of ideas and of economic activities for formation of business clusters, they also offer thriving arts and culture scenes (Glaeser 2011). Residents have access to skill building opportunities such as university education and business apprenticeships, which bolsters human capital that then underlies business growth.

Economists often use a term called 'agglomeration' to describe this phenomenon. As economic activity takes place in close proximity to each other, businesses begin to specialize and offer services others lack. This specializa-

tion lowers production costs, attracts a diverse pool of labour, facilitates exchange of knowledge and skills, and spurs entrepreneurship. When clusters of such activity begin to form, they enable higher productivity and attract investment and innovation.

Agglomeration, along with fast paced rural to urban migration, can provide increased manufacturing potential. Pakistan, however, has not yet benefited from this spatial transformation. Pakistani cities vary in size in terms of their economy and potential to generate employment.

However, if misgoverned, unplanned cities can propel countries into discontent and further economic and political instability. Moreover, urban growth without a shift in economic patterns may also become non-inclusive (in service delivery) and unsustainable (if it does not create enough productive jobs) and lead to rising urban poverty.

Misplanned cities can reverse economic gains. While the history of urban economic development has shown that cities can become harbingers of prosperity and growth, this is only possible when city governments are able to make public services widely accessible (Glaeser 2011). Hence local governance mechanisms become critical tools for service delivery and

attaining the required development and economic outcomes. For example, for urban labor markets to function efficiently, the entire workforce regardless of gender or socio-economic status must have ease of mobility through public transportation services and similarly, manufacturing businesses must access an uninterrupted supply of power and water to maintain competitiveness.

Recent policy experiences from around the world have also shown that sustained regional economic growth, with the potential to pull millions out of poverty and improve quality of life for all, requires cities to become centers of innovation and substantial productivity improvements (Florida 2002).

Therefore, to achieve economic growth, stimulating urban economies should be at the forefront of any government's overall economic strategy as more efficiently functioning cities and towns can help translate investment policies toward social welfare enhancements.

This note produced with support of Government of Khyber Pakhtunkhwa, presents a strategic framework to think about enabling KP's urban centers on a path of economic growth and prosperity such that it sustains development gains for the entire province while ensuring spill overs for the rest of the country.

1.2

ABOUT THIS POLICY NOTE

1.2.1

MOTIVATION

After years of instability, conflict and violence that marred the early years of the 21st century, the dramatically improved security situation has enabled the provincial government of KP to re-prioritize economic development as the key objective of all public policies. With a series of signature initiatives, KP maintains a twin focus on large-scale social welfare programs (e.g., public health insurance) on the one hand, and job generating industrial policies (e.g., Rashakai special economic zone) on the other. In the annual budget 2020-21, despite significant revenue shortfall due to Covid, the government spent 18% and 13% of all expenditures on education and health sectors, respectively. To sustain the long-term growth trajectory, major investments are underway in the energy and hospitality sectors, besides facilitation and outreach efforts to stimulate domestic and foreign investments.

As part of the China Pakistan Economic Corridor (CPEC), massive new infrastructure investments in highways, canals, power plants and special economic zones are underway across KP, which the government expects to generate jobs and improve industrial competitiveness. Building off of these developments, the government is now considering strategies for stimulating the

urban economy, which could further bolster growth and improve quality of life for residents.

With a population of 35 million people, KP contributes almost 10% to Pakistan's GDP. Urban KP has grown by almost 3% annually in the past two decades, leading to substantial agglomerations in the central region and Hazara region. It is estimated that today more than one in five citizens in the districts of Peshawar, Swat, Kohat, Nowshera, DI Khan and Abbottabad reside in urban areas!

KP's high urban population growth rate and the emergence of urban agglomerations account for a significant proportion of the population while highlighting the importance of cities in the on-going structural transformation in the province. This points towards the need for a coordinated public policy designed to harness the potential of these urban agglomerations as engines of growth, and at the same time deal with the potential downsides of ill-planned urban development, manifesting as slums, rising poverty, low-quality housing, congestion and contagious disease and reliance on low wage jobs.

While new urban policies can go hand-in-hand with the broader policy developments, both in terms of delivering economic benefits from infrastructure investments to a wide-ranging population and supporting the successful delivery of new industrial and infrastructure initiatives, the province will need to formulate and pursue a strategy that guides urbanization

away from its adverse consequences as the challenges here are as great as can be the failures of policy.

The disproportionate impact of Covid on the urban economy of KP also necessitates the need for a rapid urban recovery. The Pakistan Bureau of Statistics (2021) recent national survey shows that 67% of urban households in KP report reduced income during the pandemic, much higher than both the national average (53%) and the national urban average (57%).

This is of concern, particularly as KP had just begun to recover from the effects of years of terrorist violence that disproportionately impacted lives of its citizens (Shapiro et. a. 2012). Building back better, in this context, requires robust economies that can bounce back, generate employment and generate revenue – all essential to fund public investment in the essential functions assigned to city governments and administrations, which include public transport that can improve labour market opportunities; clean drinking water and sanitation that are critical for human capital and the capacity to implement vaccination programs and job creation.

Robust urban economies will also allow city governments and administrations to build the capacity to both withstand Covid-19 like shocks in the future and to react to them in a timely manner.

1.2.2

KEY OBJECTIVES

The Government of Khyber Pakhtunkhwa (GoKP) recognizes the importance of reforming the urban economies to ensure sustainable development and ensure provision of these critical public investments. In this context, the objectives of this note are to:

- a)** Review the state of urban economic development in the province informed by the best available data.
- b)** Identify bottlenecks to economic growth.
- c)** Recommend policies for stimulating the province's urban economy.

This policy note summarizes the best available data from official sources and satellite imagery to establish a baseline understanding of the state of urbanization in the province, before identifying bottlenecks to growth including dramatic intra-district variations in development outcomes and suggesting a series of policy measures to improve the status quo. Any policy or plan to reform urban economy must

acknowledge ground realities and underlying nuances across regions and segments of the population (including socio-economic development). Rather than an exhaustive list of potential policies, or a well-organized action plan with careful attention to sequencing and scale of intervention, it is intended to generate a policy dialogue among policymakers and subject matter experts to undertake evidence-informed decision making that will shape the province's urban future.

Given the central role that good urban governance plays in delivering basic public services to citizens and local businesses, KP's local government system appears throughout the policy note as a cross-cutting theme. Building on this, a follow-up policy note will soon be produced that will focus entirely on the local government system, including public financial management.

CAN URBAN CENTERS DRIVE GROWTH IN KP?

- 1.1 Role of Cities in Shaping Economic Growth
- 1.2 About this Policy Note
 - 1.2.1 Motivation
 - 1.2.2 Key Objectives

KEY MESSAGES

- Through the China Pakistan Economic Corridor (CPEC), the government is launching new special economic zones, powerplants and highways intended to overcome persistent infrastructure shortages that have stifled growth for decades.
- On the other hand, at the microlevel the government is making unprecedented budgetary outlays for basic development sectors like health and education, besides large-scale social protection, and cash transfer programs for the uplift of the underprivileged.
- KP's cities should become the connective tissues between these ambitions, by ensuring technology transfers that improve competitiveness of local firms and gains from regional connectivity and trade, directly enhancing social welfare.
- Any policies to stimulate KP's urban economies should be premised on a clear understanding of the local context (socio-economic and regional disparities) existing bottlenecks, their underlying causes and the expected drivers of economic change.

02

As CPEC brings much needed capital investments in connectivity, Special Economic Zones (SEZs) accelerating industrialization and energy fueling manufacturing, potential social welfare benefits will in large part be mediated through urban economies. For example, as foreign companies relocate manufacturing facilities into the Rashakai SEZ, they will require first-rate amenities for their workforce in order to attract and retain top national and international talent in fact, given proximity

to Mardan and Peshawar, firms will also rely heavily on workers from these cities. To become export competitive, firms would also require well-functioning ancillary services such as dry ports and wholesale centers, and in the longer-term, a steady supply of locally trained talent with industry-relevant skill sets (Gennaioli et al. 2012).



Figure 1: Conceptual Framework: CPEC Investments, Urban Policy and Social Welfare

In other words, if the path to prosperity for KP's population starts from CPEC and ends in measurable improvements in social welfare, it will likely go through its urban economy.

WHAT CAN HELP CITIES GROW?

Creating productive jobs: The movement of people is determined largely by the type of jobs and where they are created. Cities must produce employment opportunities that would make migrants relatively more productive. The challenge is not just about creating more jobs. When available, jobs are usually of low quality, especially in manufacturing and services. A key factor inhibiting labour productivity remains the low accumulation of human capital. The ability of individuals to participate in the labour force may further be constrained by poor health. Hence complementary investments in health and education remain critical.

Urban transport for labor market integration: A well-integrated urban public transport network contributes to economic growth by reducing transport costs and travel time, facilitating specialization of firms and workers, and decreasing the cost of economic transactions. However, KP's rapid urbanization is challenging the flimsy infrastructure of its cities, constraining economic activities and reducing potential of growth. Several transportation projects are being rolled out across cities without much understanding of

their economic benefits or the local job market.

Sectoral focus on manufacturing: Transforming the quality and quantity of jobs will require an expansion of manufacturing, especially in the value-added segment, since every job in manufacturing creates 2.2 jobs in other sectors. Hence, manufacturing remains key to reviving the economy. Manufacturing can be encouraged by pushing industries and businesses that are export-oriented, or have considerable export potential, require little capital and are labour intensive, use relatively less energy and are densely populated by Small Medium Enterprises (SMEs). Evidence shows that economies with strong SMEs are progressive and experience robust, economic, growth. In the case of Pakistan, housing and real estate sectors are directly linked to about 42 construction materials' industries, creating jobs at much higher rates.⁵ While easing housing pressure on cities, investing in low cost housing may also boost SME business in Pakistan.

Create special economic zones: Provinces have not yet designed industrial policies that look at land usage and development of new

cities, even though industrial investments under the China Pakistan Economic Corridor (CPEC) have already begun. Special economic zones can provide enormous opportunities for boosting employment and job creation. If these projects are launched in the vicinity of densely populated areas and urban centers, they can make a win-win scenario for the community and the industry. In such a case, these projects can also develop close integration with the local industry. These projects can further result in urban knowledge spill-overs to help develop a knowledge-based economy. However, outdated land use regulation and building codes, the absence of a unified land record system and patchy data on land use can continue to lead to poor urban land management.

Source: <https://devpakblog.com/2019/05/20/urbanization-and-growth/>

However, any policies for stimulating the province's various urban economies should be premised on a clearer understanding of existing bottlenecks, their underlying causes and the expected drivers of economic change. Three factors are critical: role of local governments and the underlying regional and gender disparities.

Underlying governance: To realize the full potential of CPEC, substantive improvements will be needed in urban governance and fiscal discretion to manage their own affairs (Smoke 2003). If they are responsible for local services, they must also be entitled to set service delivery fees to be adequately resourced and have powers to hire and fire administrators of service delivery units (Boex et al. 2012). Besides authority and resources, they must also receive capacity building investments through higher levels of government, particularly provincial agencies with technical knowhow.

Regional disparities: KP features multiple regions including the newly merged former Federally Administered Tribal Areas (FATA) districts, sparsely populated mountainous

areas to the north and the densely populated central plains. They exhibit great variations in levels of urbanization (45.5% in Peshawar vs 0% in Bajaur), population density (1,623 people per sq. km. in Peshawar vs only 30 in Chitral), level of industrialization (169 running industrial units in Haripur vs only 4 in Hangu) and per capita energy consumption (422 kWh per person in Nowshera vs 138 kWh in Lower Dir)². On all development outcomes, newly merged districts of the former FATA are lagging by large margins and the vast majority of their population lives in rural conditions. This presents both opportunities for generating economic opportunities (also the government's key strategic priority for merger) and challenges in building up human capital, stimulating investments and generating employment opportunities for the youth.

Socio-economic disparities: Similarly, socio-economic indicators exhibit strong gender disparities at the level of the province's urban population. This includes unemployment in urban areas (8.3% among males vs 18.8% among females), rate of literacy among urban residents (81% among males vs 53% among

females) and enrollment in 4-year bachelor's programs (35,446 males vs 16,660 females). The province's urban economic policy thinking must consider ways to stimulate economic growth through aggregate productivity improvements while fully tapping into the full pool of the human talent available. Studies show that besides restrictive social norms limiting women's activities outside their homes, they experience severe practical challenges in being fully mobile within cities (Zolnik et al. 2018). So future urban public transportation projects for example must take into account women's particular safety perceptions and travel needs to ensure they enjoy equitable access to services and thus fully contribute to the urban economy.

By developing policies, mindful of these factors, reform measures can help create a future where KP's cities can become the hubs of innovation for businesses offering a higher quality of life for citizens and enabling equitable economic growth that works for all segments of society.

Source: ²KP's BoS data and KP's development statistics 2020.

STATE OF URBANIZATION IN KP

- 3.1 Population Growth and Density
 - 3.1.1 Urban Population Growth
 - 3.1.2 Rate of Urbanization
 - 3.1.3 Population Density
- 3.2 Urban Agglomerations in KP
 - 3.3 Size and Structure of the Provincial Economy
 - 3.3.1 GDP Estimates
 - 3.3.2 Leading and Lagging Districts in KP
 - 3.3.3 Clusters of Growth
- 3.4 Employment and Labor Markets
 - 3.4.1 Employment Trends and Data
 - 3.4.2 Employment Opportunities
- 3.5 Public Service Delivery

KEY MESSAGES

- KP's process of urbanization is still nascent even by Pakistan's national standards. It's 33 districts hosting a population of over 35 million face distinct challenges and opportunities toward stimulating their urban economies.
- KP is urbanizing but slower than the rest of Pakistan. Population grew almost everywhere, but rates of growth and urbanization varied dramatically. District level rates of urbanization vary dramatically, from over 45% in Peshawar and 30% in Swat, to nearly 0% in much of the newly merged former tribal areas, leading to varying densities.
- Using proxies to measure economic performance Haripur and Peshawar emerge as KP's economically leading districts, while northern districts such as Mansehra, central areas around Bannu and the southern region around DI Khan is lagging behind.
- University students are harbingers of creativity and innovation, but this population in KP is largely based in Peshawar, Mardan and Abbottabad with around 3,500 students each, but there are another 18 districts with less than 1,000 students in 2014.
- Out of 2,247 operational industrial units across KP, more than 1/4th are in Peshawar district alone with nearly none in places like Shangla (2) and Hangu (4) pointing to massive disparities in industrialization.
- Human capital is accumulating into a handful of leading districts, likely at the cost of lagging districts from where lack of opportunities is forcing workers out, but greater regional connectivity linked to employment-generating SEZs can help create better economic outcomes.
- Even the relatively prosperous districts of KP are unable to serve large proportions of their populations with basic urban services, due to weak local governments.

03

3.1

POPULATION GROWTH AND DENSITY

3.1.1

URBAN POPULATION GROWTH

With a population of 35.5 million, only 18.7% of KP's population lives in urban areas ([Pakistan Bureau of Statistics 2017](#)) which is by far the lowest among all provinces of Pakistan, less than half of the national average of 36.4% and Punjab's average of 37%³. Only 7.8% of Pakistan's urban population is in KP. Between 1998 and 2017, the overall rate of population growth of 2.89% was higher than the national average of 2.4%, mostly driven by growth in urban areas.

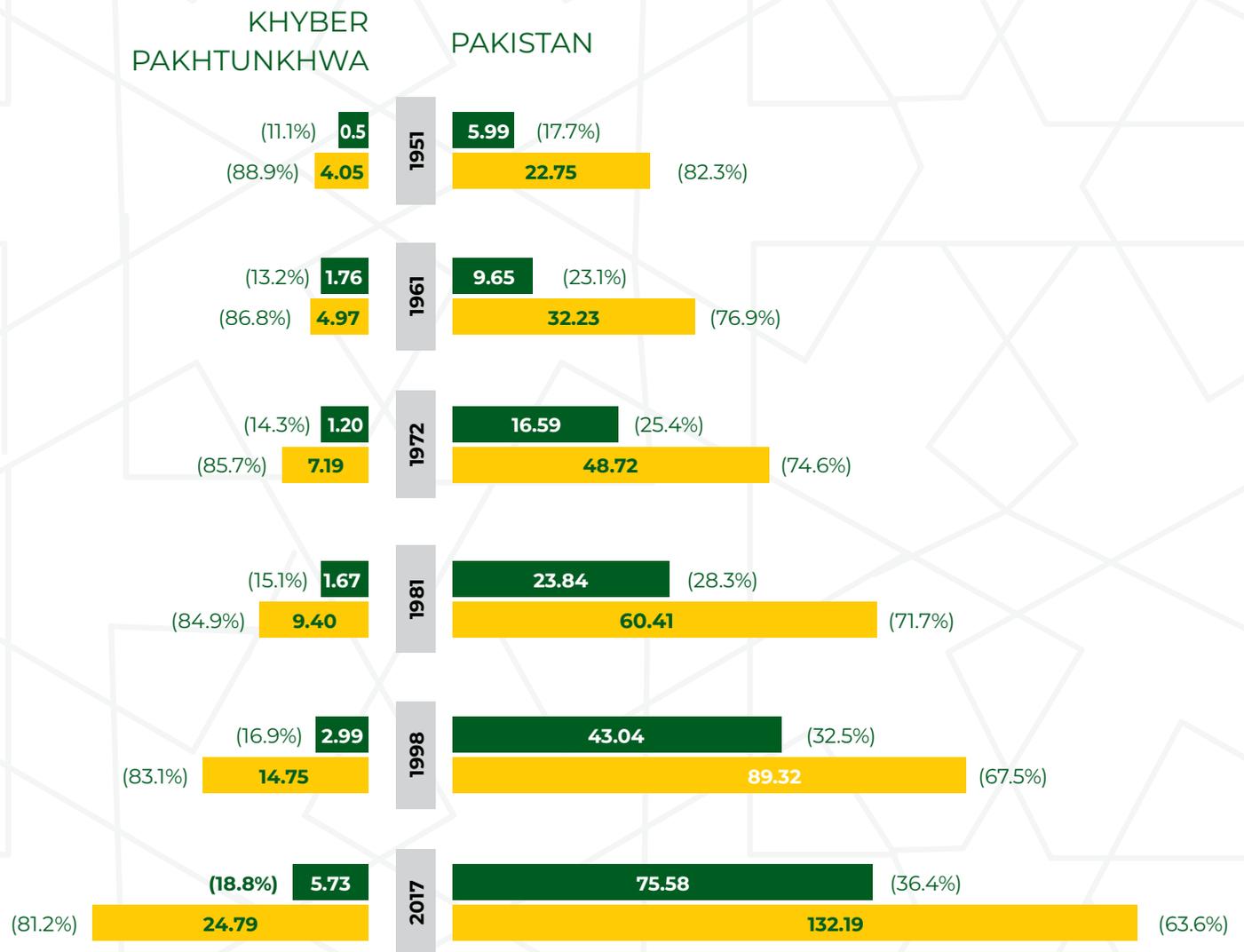
Since the 1981 census, the rate of urbanization in KP has nearly doubled from 8.5%, though most growth took place since 1998, when urbanization was still only 10%.

This documented increase in urban population of nearly 2.8 million urban residents between 1998 and 2017 presents a massive challenge for provincial and local authorities charged with delivering urban amenities and public services. *However, despite this momentous transformation of population patterns, urban local governments in KP today are perhaps less empowered and capacitated than in the 1980's to deliver basic public services in a transparent and engaging manner.*

³ Unlike the PBS website which reports KP and FATA's statistics from the 2017 census separately, in this brief all data reported on KP combines the newly merged, former FATA districts based on the author's own calculations

URBANIZATION LEVELS IN KP OVER THE YEARS

■ Urban Population in Million
■ Rural Population in Million



Source: UNDP, 2019. Development Advocate: Pakistan-Sustainable Urbanization.
 (Includes the population of erstwhile FATA and Islamabad)

3.1.2

RATE OF URBANIZATION

Within the province, district level rates of urbanization vary dramatically, from over 45% in Peshawar and 30% in Swat, to nearly 0% in much of the newly merged former tribal areas. In fact, today nearly one-third of all urban residents (~2 million) in the province live in Peshawar alone, not including the greater Peshawar region which could also include cities within an hour or so drive from Peshawar city

as Mardan (0.44 million), Charsadda (0.27 million), Nowshera (0.39 million) and even Kohat (0.27 million). While this central region certainly hosts more than half of KP's urban residents (~3.6 million), there are also large urban populations in the mountainous districts of Swat and Mansehra, and the southern district of DI Khan.

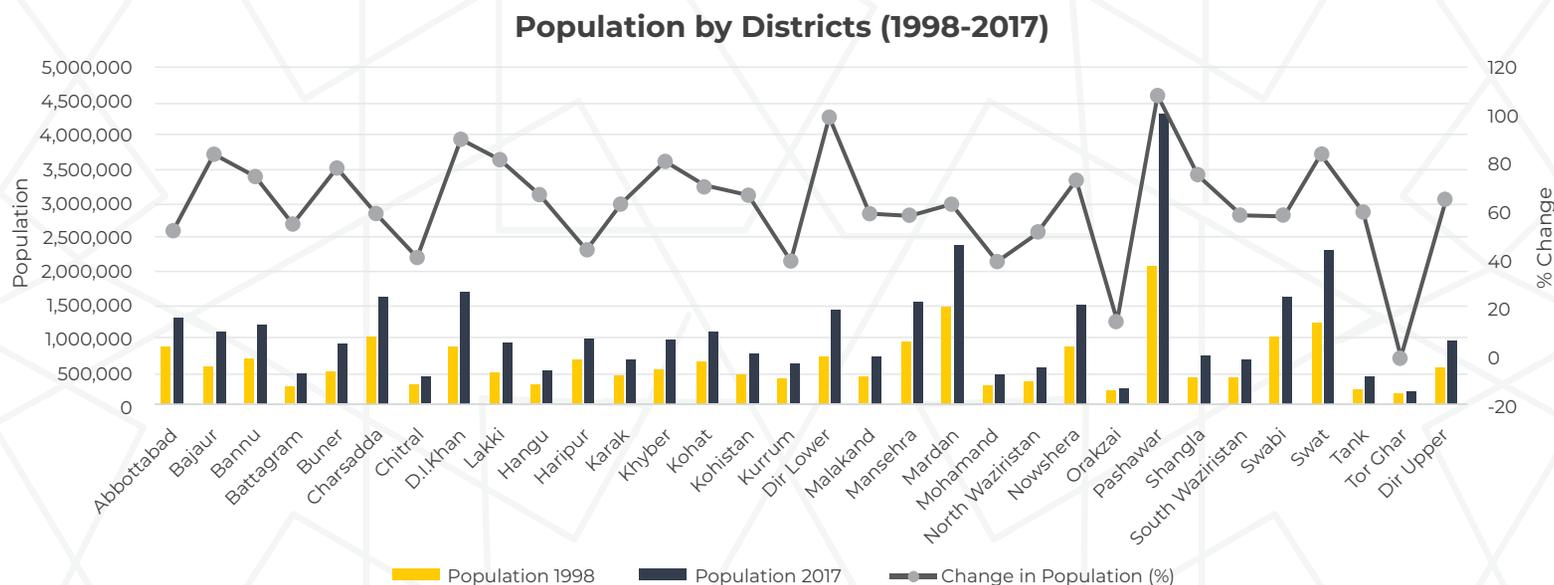


Figure 2: Urban populations by district (1998 – 2017)

Six districts in KP have urban shares that exceed 20% of their population. Slightly less than half of Peshawar district's population resides within urban limits; around one-third of Swat's population also resides within city limits; and more than one-fourth of Kohat's population is urban.

The fastest growth between 1998 and 2017 has been registered in Peshawar (100%+), Lower Dir (100%) and DI Khan (90%+), whereas mountainous regions like Chitral (40%) and Haripur (~45%) and former FATA districts like Kurram (~38%) and North Waziristan (50%) appear to have more stable population levels.

3.1.3 POPULATION DENSITY

These sharp variances in population patterns extend into districts' density levels, which range from 2,854 people per sq. km. in Peshawar to only 30 people per sq. km. in the mountainous district of Chitral, with an additional 7 newly merged districts housing less than 200 people per sq. km.

Even though KP's overall average household size has fallen slightly from 8.0 in 1998 to 7.93 in 2017, it remains significantly above the national average of 6.39 ([Pakistan Bureau of Statistics 2017](#)).

Despite being the third most populous province in the country, KP's 2017 population density of 409 people per square kilometer is 56.7% higher than the national average.

These stark differences can be explained by economic and social factors driving inward migration, including educational and employment opportunities, social and ethnic ties and proximity to markets

3.2 URBAN AGGLOMERATIONS IN KP

KP has also seen the emergence of urban agglomerations in its central region and Hazara regions – the two identifiable agglomerations. The urban cluster in the central region consists of the districts of Peshawar, Charsadda, Mardan, Nowshera and Swabi and comprises a third of the province's total population and half of its urban population⁴. The urban cluster in the Hazara region consists of the districts of Haripur, Abbottabad and Mansehra. It contains approximately 10% of the province's total and urban population.

Large segments of the population connected to these agglomerations in fact reside outside administrative boundaries of municipalities, and “ribbons” of development along the highways have evolved, largely to benefit from accessibility to these urban centers or clusters.

All districts in the central region's urban cluster have population densities that exceed 1,000 persons per square kilometer, with Peshawar

district having a population density of over 3,300 persons per square kilometer⁵. In fact, satellite images indicate that more than half of the urbanized area of Peshawar city, is actually counted as rural⁶.

There are pros and cons to this trend of urban development. Advantages include potential synergies due to proximity to human resources, knowledge, technologies and markets. However, this ongoing urban transformation, in the absence of land-use regulations and zoning laws, is also giving rise to the downside of densification in the form of slums, congestion, stressed municipal infrastructure and rising poverty. Addressing these require public investment and policy responses particularly if urban areas are to fulfill their potential as engines of growth and development.

Such an urban sprawl can also place undue stress on the local government as unofficial “urban” regions continue to use services designated for urban centers, use transport infrastructure, and may not pay their share of taxes and user charges.

⁴Seed policy note on property tax

⁵Seed policy note on property tax

⁶<https://www.adb.org/sites/default/files/project-documents/49050/49050-001-tacr-en.pdf>

3.3

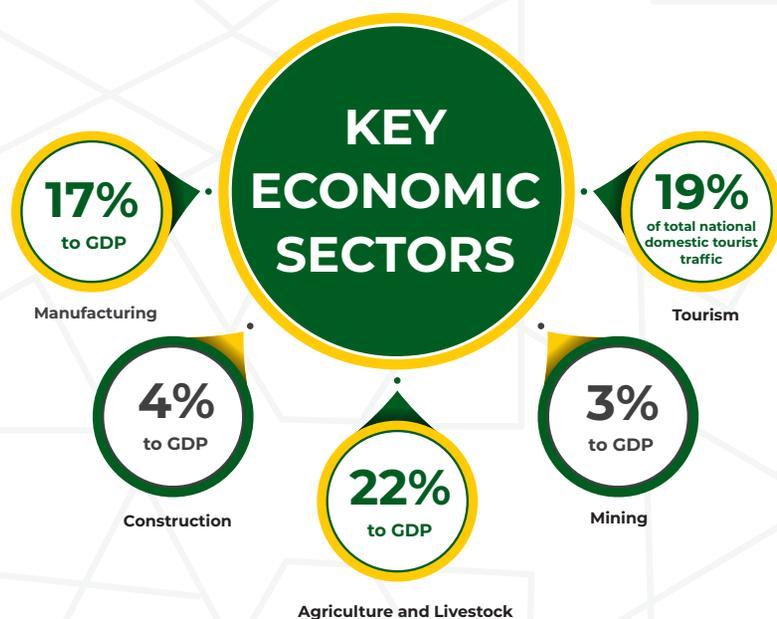
SIZE AND STRUCTURE OF THE PROVINCIAL ECONOMY

3.3.1

GDP ESTIMATES

Overall KP's economy shows low real GDP growth. Its real growth is 5.5% and with a population growth of 2.9%, real per capita GDP growth is only 2.6%. Yet KP's cities are the main creators of economic wealth and generate over 70% of the provincial GDP⁷.

The services sector accounts for 60% of provincial GDP, while the agriculture sector accounts for 16.87%. The key economic sectors and their contribution to KP's economy are shown below.



While the government of Pakistan does not publish district level official GDP numbers, a recently completed analysis of night light intensity as a proxy for economic activity level reports highest per capita income levels in Karak, Haripur and Peshawar and lowest levels in Mansehra, Chitral and Tor Ghar (Hasan 2021). In terms of per capita electricity consumption (a potentially useful proxy for per capita income), according to official statistics Haripur, Nowshera and Peshawar top rankings, followed by Mardan, DI Khan and Tank in the middling category and Bannu, Karak and Mansehra at the bottom. Even though nightlights are imperfect estimates and power consumption is obviously skewed in favor of industrialized areas, these statistics make obvious that the likes of Haripur and Peshawar are KP's economically leading districts while northern districts such as Mansehra, central areas around Bannu and the southern region around DI Khan are all lagging regions. The highest income earning districts are Peshawar and Nowshera but lowest earners like Shangla and Dir Upper are 8 times lower.

⁷<https://www.adb.org/sites/default/files/project-documents/49050/49050-001-tacr-en.pdf>

3.3.2

LEADING AND LAGGING DISTRICTS IN KP

The economic dominance of the Peshawar Valley cluster is confirmed by the region's high intensity of nightlights (Figure 5) as compared to other similarly sized areas within the province. The red dot indicates the approximate location of Rashakai SEZ, which appears well positioned to create positive spillovers in the nearby economic centers of Peshawar and the greater Islamabad-Rawalpindi region. In comparison, the almost entirely dark circles of the newly merged western districts and even the south-eastern districts bordering the Punjab are another reminder of the stark contrast between lagging and leading districts within KP.

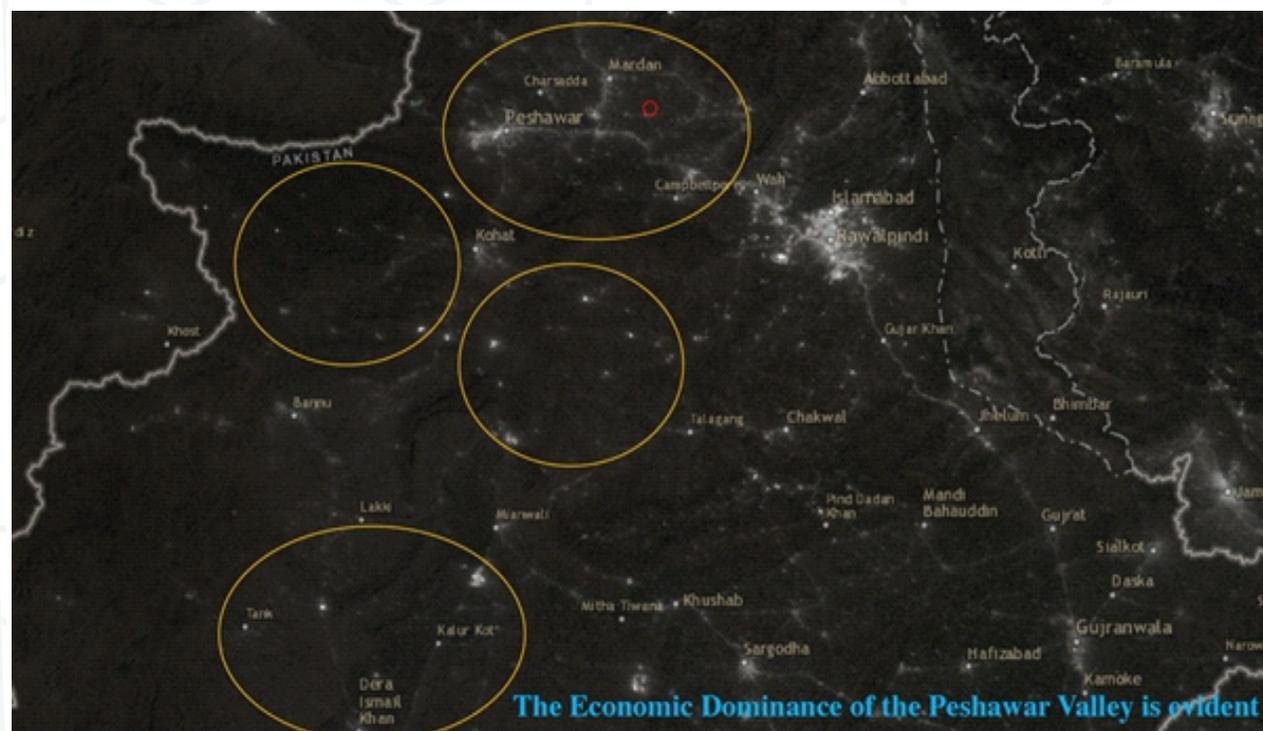


Figure 5: Peshawar Valley's Domination of the Provincial Economy

Greater regional connectivity linked to employment-generating SEZs such as Hattar and Rashakai can help create better spatial outcomes in terms of greater spreading out

of economic benefits. More than half (56%) of KP's urban population lives within commuting distance to Rashakai SEZ.

3.3.3

CLUSTERS OF GROWTH

Despite the lack of information on each district's biggest employment sectors that could reveal their economic structure, or accurate information on the quality of public services, data analysis shows that the province is divided into at least three economic clusters.

1. First, the central districts of Peshawar Valley along the river Kabul, including the districts of Mardan and Charsadda which due to the M-1 motorway are increasingly well connected to each other's wholesale and retail markets, to the rest of the country through the improved national highways network and internationally through the Peshawar and Islamabad airports.

2. Second, several districts spread in the northern areas including Dir and Chitral to the northwest and Kohistan and Mansehra to the northeast, which are relatively poorer and underserved, in part due to difficult to reach mountainous terrain.

3. Third, the southern region bounded by DI Khan to the southeast and Lakki Marwat and Bannu to the north, which borders several FATA districts bordering Afghanistan and are relatively disconnected from the province's manufacturing and trading hub in the Peshawar Valley and not fully integrated with major markets in nearby Punjab.

3.4

EMPLOYMENT AND LABOR MARKETS

3.4.1

EMPLOYMENT TRENDS AND DATA

Generally, KP has the highest unemployment amongst all provinces. Unemployment rate is 7.2% in KP with 0.55 mn the unemployed. Most of the labor force is concentrated in rural KP with agriculture sector being the largest employer. However, unemployment is higher in urban KP (8.3%) than in rural KP (6.9%). Agriculture is also the largest employer (38.4%), followed by manufacturing (16%), wholesale and retail and repair of motor vehicles and cycles (14.9%) and construction (7.61%).

The informal sector in KP is very significant⁸. Informally employed persons in KP amount to 52.3% of the labor force involved in non-agriculture employment (67.38% of all employment in the province). The largest sectors with informal employment are construction (25.4%) and wholesale, retail trade, and vehicle services (28.2%). These are also the largest informal employing sectors at the national level⁹.

⁸Labor force survey 2017-18

⁹<https://www.adb.org/sites/default/files/project-documents/49050/49050-001-tacr-en.pdf>

3.4.2

EMPLOYMENT OPPORTUNITIES

In terms of employment opportunities, out of 2,247 running industrial units across KP, 679 are in Peshawar district alone while the likes of Shangla (2) and Hangu (4) only boast a handful, which is why industrial labor force is most likely to migrate to the greater Peshawar region. Another key reason why young professionals migrate to certain cities is educational opportunities, which also shows stark intra-district variation. Out of 35,807 students enrolled in four-year bachelor's degree programs around the province in 2014, the top four districts of Peshawar, Mardan, Abbottabad and Swat host around 10% each, whereas 18 out of 33 districts have less than 1,000 active

students and at least a dozen had none at all ([Pakistan Social and Living Measurement Survey 2014](#)).

While inter-district migration is difficult to trace, it is obvious that human capital is accumulating into a handful of leading districts, likely at the cost of lagging districts from where lack of opportunities is forcing workers out. In addition, almost 44% of the population in KP is under 15 which implies that a large segment of KP's population is about to enter the work force. To accommodate this growing workforce, number of employment opportunities in urban centers must grow.

3.5

PUBLIC SERVICE DELIVERY

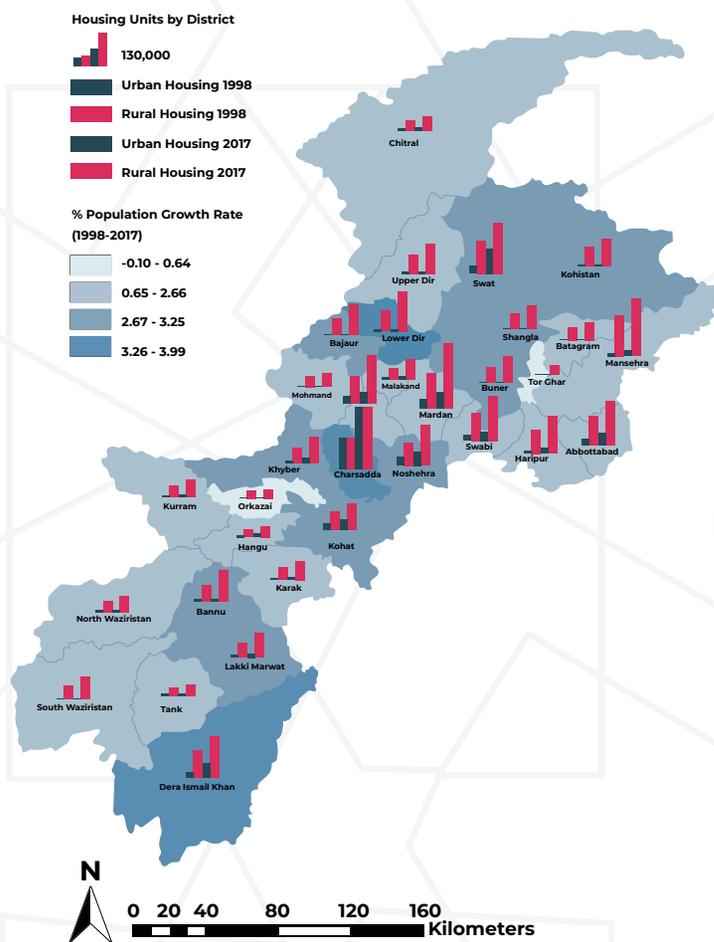


Figure 3: Changing in Urban and Rural Housing and Population Growth Rate (1998 - 2017)

The intra-district disparities manifest themselves in the housing sector, where demand for new units far outstrips supply resulting in poorer average housing conditions and greater pressures on archaic public service delivery systems originally designed for smaller populations.

Evidently, these patterns impose greater burdens on urban public service delivery systems throughout the province. But this is particularly challenging in districts like Peshawar experiencing rapid demand growth and mountainous ones like Swat where greater capital investments are needed to improve coverage to large swaths of the urban population.

Given the path-dependent, networked and scale-dependent nature of most public service delivery infrastructure, greater levels of urban population densities can help make public service delivery more affordable (Collier and Venables 2016). Because incoming investments

in industrialization and regional connectivity will only stimulate further urbanization due to greater expected labor demand, KP's cities will experience further sprawl featuring even more low-density residential enclaves making it harder for municipalities to deliver public services.

While district level data on the quality and coverage of municipal services is difficult to collect, proxies such as proportion of households with piped water access and household size are useful indicators. Here too we find strong variations with one-third of all districts including Mansehra reporting universal piped water coverage in 2014, whereas another one-third including Shingla, Khyber and several other former FATA districts had no piped water coverage. In terms of local law enforcement and security services, there are similarly large variations ranging from 427 reported cases in Peshawar district in 2019 to only 4 in Chitral during the same year.

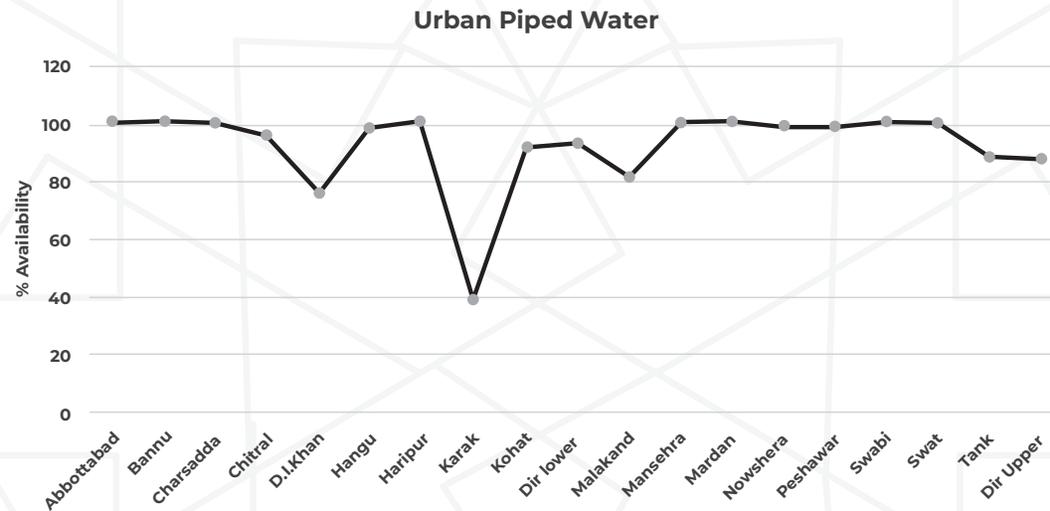


Figure 4: Piped Water Coverage by District (2014)

In the backdrop of weak local governments, it is unsurprising that even the relatively prosperous districts of the province are unable to serve large proportions of their populations with basic urban services that underlie quality of life for their residents. As an example, KP currently collects \$0.1 per capita in property taxes (the most important local tax), which is 8 times less than the tax collected in Punjab and 129 times less than the tax collected in Indian cities that have introduced property tax

systems based on property value. The inability of city governments to finance municipal services for a growing population is resulting in overcrowding and serious deficits in access to water and sanitation with adverse effects for health and human development.

Currently, 39% of the rural population lives below the poverty line and many more live just above it. 258 Urban dwellers, however, seem not much better off and also use at least 90% of

their income for consumption. Only households in the highest 20% of income can save over 10% of their income. In KP, urban residents are able to save a few percentage points more than the national average but rural dwellers in KP are significantly worse off. Across the board, they spend more on consumption and may even spend more than their income.

KEY EMERGING PATTERNS

1. KP's cities are bunched together in distinct clusters as evident in highway connectivity, night lights and population density patterns.
2. Employment patterns show great heterogeneity in structure of local economies, e.g. Peshawar's preminent status as trading hub of the region, and the need to create interdependencies for greater gains from trade.

3. General state of public service delivery is poor as compared to international standards due to administrative and fiscal challenges including non-existence of representative local bodies.

BOTTLENECKS STIFLING URBAN ECONOMIC GROWTH

- 4.1 Inefficient Land-Use Patterns
- 4.2 Inadequate Provision of Public Services
- 4.3 Sub-Optimal Trading Markets
- 4.4 Spatial disparities across districts

KEY MESSAGES

- Urban land-use patterns indicate lack of efficiency due to underutilization of highly valuable inner-city (or downtown) land parcels while rising sprawl is leading to the expansion of urban footprints into previously fertile agricultural farmlands.
- Rapid expansion of cities, lack of capacity and resource allocation at the local level has nearly crippled municipalities' ability to provide basic urban public services that underlie quality of life for residents.
- Peshawar must reclaim its role as a hub of regional trade along the east-west corridor.
- There are massive social, economic and spatial disparities across KP's various divisions, which feature a robust center in Peshawar Valley and several hinterland areas with significantly lower economic output.

04

The urban economic system of KP faces several key challenges before it can attain its full potential as the bridge between public investments in infrastructure and social welfare. Not unlike other cities in Pakistan, KP's urban centers face several bottlenecks related to land-use regulations, governance of public service delivery, efficiency of marketplaces, spatial disparities across districts and provision of urban amenities for attracting and retaining human capital. Whenever market failures afflict these areas, such as due to poor intracity mobility or dysfunctional land-use markets, carefully designed public policy interventions are required to create improved economic outcomes benefiting businesses, residents, and the public sector. With this lens, KP's urban economic system exhibits several challenges requiring careful analysis followed by robust policy responses.

4.1

INEFFICIENT
LAND-USE PATTERNS**72.9%**

is either bare land or with natural vegetation coverage or other non-agriculturally suitable conditions

**LAND
USE****2%**

of KP is built-up settlements

25.1%

of KP's total land area is used for agriculture

Source: <https://www.adb.org/sites/default/files/project-documents/49050/49050-001-tacr-en.pdf>

1. Central land parcels being used for non-commercial activities, increasing sprawl.
2. New residential housing schemes in larger cities creating pressures on infrastructure.
3. Local regulations are preventing high population and economic density.

KP's major urban centers exhibit inefficient land-use patterns whereby central land parcels remain under- or unutilized mostly due to restrictive zoning rules maintaining low-density levels (Haque 2015). As a result, the demand for new housing units is being met by the private sector in the form of housing projects in peri-urban areas around cities, where land is cheaper and road access is easier. Precious agricultural land in KP is being converted into illegal urban housing schemes, which is a trend needing reversal. With little or no oversight by public departments of planning or local authorities, and no certain allocation of additional sources for public service delivery units, these newly built areas deteriorate rapidly soon after project completion. In addition, with most employment opportunities still located within central parts of these cities, workers face significant challenges in commuting to work given the generally poor state of public transportation (Witte et al. 2019). Thus, this misallocation of land resources causes disruptions into the critical realms of public service delivery and labor markets, which both inhibit quality of life.

Moreover, a significant proportion of the population connected to urban agglomerations in KP resides outside the administrative boundaries of urban areas along highways creating an urban system that includes peri-urban localities. This indicates a high level of urban sprawl. Almost 60% of KP's population lives within a travel time of one hour of a city and 90% within two hours but these regions are still considered rural.

Spatial images suggest a much higher percentage of residential land use in the urbanized area due to a lack of planning, resulting in a low-density sprawl beyond official boundaries. Spaces allocated for recreational open places, including open green spaces, also fall far below the recommended 10 to 15%.¹⁰ An updated KP Provincial Land Use Plan is currently being prepared to address these challenges, but local governments must also be asked to take charge of its implementation.

¹⁰<https://www.adb.org/sites/default/files/project-documents/49050/49050-001-tacr-en.pdf>

4.2

INADEQUATE PROVISION OF PUBLIC SERVICES

1. Local urban governance systems are incapacitated and under resourced to deliver services.
2. They don't have administrative, fiscal, and political space necessary to transform a thing.
3. Urban labor markets, in part due to poor transport services, are suboptimal.

Second, the quality and coverage of basic public services usually under the responsibility of municipal authorities, such as water, sanitation and solid waste management, is inadequate for the growing needs of KP's cities. Studies show that piped water reaches less than half of KP's urban population for limited durations and sewage waste generated by 85% of this population flows in open drains (ADB, 2020; Mansuri et al., 2018). The chronic resource constraints and lack of citizen-responsiveness is

urban local governments that are responsible for delivering services. As compared to regional peers like India and Bangladesh, and even several countries across Africa, local governments in Pakistan simply do not have the administrative, fiscal or political space necessary to run their own affairs (Boex et al. 2012).

When major capital investments have been made in urban public transport in recent years for example, projects have been directly

planned and executed by provincial or federal governments, without any substantial initiative of city governments. Thus, the design and operations of public transport are never discussed with communities, who are often displaced due to these megaprojects that ironically, are built for their benefit. If the government's SEZ policy is to succeed, nearby cities must significantly improve public services and urban amenities so that high-quality workers could relocate to the area to make better use of available job opportunities.

4.3

SUB-OPTIMAL TRADING MARKETS

Third, in the backdrop of the Peshawar Valley's status as the region's eminent and ancient trading hub connecting Central and South Asian markets for a variety of commodities, the region's wholesale trading markets are today operating sub-optimally. While the security situation in Afghanistan has become uncertain in recent weeks, under conditions of regional peace and new regional transport infrastructure connecting Pakistan to Central Asia, the volume of trade is large enough for Peshawar to emerge as the region's pre-eminent transit and trading hub. But due to chronic under investment in customs trade facilitation, lack of supporting industries and services complementing trade flows and poor accessibility into the walled city's historic wholesale markets, Peshawar has failed to realize its full potential.

In addition to these infrastructural shortcomings, KP's industrial and entrepreneurial

1. Despite highway improvements, wholesale and retailing markets for commodities and poor rural-urban economic integration via supply chains inhibiting equitable growth.
2. The entrepreneurial venture being stifled due to low awareness and risk-aversion

systems suffer from under investment that has prevented local businesses from offering value added services such as in the realm of logistics that build-off of transit trade flows. For example, fresh and dry fruits farmed in rural KP and Afghanistan for exports could use international quality processes, repacking and shipment services provided by local businesses based in KP's cities. But in reality, entrepreneurs suffer from several challenges preventing them from achieving greater success: information gaps in terms of knowing when, how and where to build such ancillary businesses; technical capacity constraints stifling their ability to adopt modern technologies that meet international standards; and lack of venture capital investments or small business loans enabling them to take new initiatives.

The KP Industrial policy of 2020¹¹ identifies several industrial sectors that dominate the

provincial economy and thus exhibit signs of competitive advantage, both domestically and in the region. It finds that in recent years, several industrial units in steel, plastic, pharmaceuticals, textiles and food sectors have closed due to instability in government policies, lack of skilled management and workforce talent and power shortages. While new SEZs undoubtedly offer great potential for reinvigorating trading sectors across the KP's economy, there are serious shortcomings in the talent pipeline due to lack of training opportunities and poor state of urban amenities that discourage high quality talent from staying in the province's cities. Urban governments could therefore play a significant role in addressing these challenges.

¹¹Source: <http://kpboit.gov.pk/wp-content/uploads/2020/02/KP-Industrial-Policy-2020.pdf>

4.4

SPATIAL DISPARITIES ACROSS DISTRICTS

1. There are massive spatial disparities within the province and an overconcentration of economic activity.
2. Their persistence can stifle the growth and social cohesion, increasing the risk of conflict.
3. Lagging districts appear disconnected from the greater Peshawar growth cluster.

Finally, there are massive spatial disparities across KP's various districts, across indicators of both well being and economic opportunities varying sharply, particularly between the leading areas of Peshawar Valley and the newly merged former FATA districts along the border with Afghanistan. Despite the improved security situation and improvements in highway connectivity, many lagging regions to the north, south and southwest of Peshawar Valley appear largely disconnected from both KP's and Pakistan's economic growth centers.

This is a nontrivial factor that necessitates a foundational rethink of the emerging spatial economic paradigm, particularly in terms of sharing the benefits of growth more broadly. But the absence of district level data on economic structures as measured by employment patterns and business value addition within national or international value-chains remains a massive knowledge gap that must be filled before spatial disparities can be addressed.

OPPORTUNITIES FOR POLICY INTERVENTION

- 5.1 Complementary Urban Investments to Benefit from Megaprojects
- 5.2 Whole of Government Approach to Meet Economic Development Objectives
- 5.3 Improving Service Delivery and Land-Use Planning via Local Governments
- 5.4 Developing Identity of Cities as Hubs of Economic Activity and Trade

KEY MESSAGES

- Enhance the benefits of agglomeration by investing in improving of service delivery and skills development
- Create singular focus across all levels of government on economic development policies
- Truly empower urban elected local governments to undertake decisions around local economic development planning and public service provision
- Help urban centers define their economic identity to inform economic planning and investment decisions

In the broader context of large-scale public investments and a strong focus on social welfare, stimulating the urban economy presents a must-win challenge for the province's economic policymakers. Through a series of interconnected and actionable steps summarized below, progress can be made toward stimulating KP's urban economy for longer-term social welfare gains for large segments of the population. Undertaking these reforms would require well-coordinated actions with provincial and local authorities leading the way with a clear-eyed vision for long-term economic development clearly communicated to all stakeholders, particularly investing businesses, and implementing public agencies.

05

5.1

COMPLEMENTARY URBAN INVESTMENTS TO BENEFIT FROM MEGA PROJECTS

Policy Direction

CPEC continues to be widely touted as a “game-changer” for Pakistan and the wider region (Gulf News 2016). In many ways, it has become the cornerstone of the country's economic development paradigm, which favors the idea that bolstering physical infrastructure will create prosperity. It follows that better inter-regional connectivity, stronger energy supply and unprecedented foreign direct investments will help local and international businesses create new jobs which then boosts aggregate domestic demand. This thinking is based on the premise that the fundamental problem of Pakistan's lack of economic development is non-availability of capital that would then stimulate growth. Even though most economic value addition takes place in urban areas, making cities work simply does not feature in this theory of change, as if self-contained SEZs interconnected with high-speed transport networks and fueled by affordable power would alone be sufficient to achieve economic development. But in reality, turning the tide of Pakistan's long-term economic fortunes requires deep reforms for creating robust economic institutions that

would create an improved business climate for corporations, support ecosystems for budding entrepreneurs and offer equality of opportunity for an internationally competitive workforce.

The only plausible mechanism by which foreign capital injection can result in economic development is if it boosts domestic economic productivity through technology transfers and improved managerial practices acquired from foreign partners (Gourinchas and Jeanne 2013). In fact, evidence from dozens of SEZs has shown that capital investments alone, even with promises from businesses to relocate, cannot overcome underlying market failures such as non-availability of adequate human capacity or land resources to support incoming industries (Duranton and Venables 2018).

MAKING SEZ'S WORK FOR ECONOMIC GROWTH

SEZs, geographical areas marked by governments for special financial and regulatory benefits, are becoming popular in developing countries across the world. SEZs offer an easier approach to implement business reforms while creating opportunities to supplement traditional economic growth. However, for SEZs to become successful, labor conditions and connectivity with local suppliers must be maintained.

In 2019, the International Growth Center (IGC) hosted an informal roundtable discussion on the merits and potential of SEZs in developing countries. Leading experts from many developing countries shared their experience on the SEZ policy framework, policy design, and policy implementation.

Some key points identified during this workshop are as follows:

- SEZs can operate as a critical policy experimentation for developing countries to address specific economic problems.
- Positive spillover effects of SEZs must be leveraged in order for the zones to have significant effect on the economy.
- SEZs can provide an opportunity to experiment with specific economic and fiscal policies. The impact can be studied in a localized environment, providing an opportunity to test the pros and cons of a policy.
- One of the main reasons why countries see limited success in achieving the maximum benefits from SEZ implementation is that strategic industries are not prioritized in these zones.
- Fiscal incentives provided to SEZs must make sure they do not negatively impact the local economy as in some cases incentives can provide a competitive advantage, pushing the local economy out of business.

SEZ's are often seen as a 'fix-all' solution, but it is rare that the high costs involved bring the intended benefits. The key is how to integrate with the local economy and not just move existing activities to another location, or worse, put existing firms out of business that cannot compete with firms part of the SEZ. They need to be special, and they need to be used to experiment new ways of overcoming specific market failures.

Source: <https://www.theigc.org/event/special-economic-zones-can-they-create-jobs-and-grow-the-economy/s>

The case of South Africa's industrial decentralization starting in the early-2000's is a case in point. While the central government poured millions into constructing several SEZs in lagging hinterland regions that were unconnected and underserved, the responsibility of providing water, power and roads fell onto resource-constrained municipalities.

After realizing that mega projects had created undue fiscal pressures at the local level, the national government introduced several funds and grants to help, but they proved inadequate (Farole and Sharp 2017).

To unlock such potential, governments need to introduce a robust set of complementary investments such as:

- Improving urban livability through public service delivery.
- Supplying a skilled workforce to fill growing job demand.
- Improving the business climate for achieving international competitiveness and for making investments to institutionalize knowledge spillovers for the benefit of domestic economic actors.

Specific Initiatives

When launching SEZs, economic planners can introduce complementary policies to sustain longer-term benefits from infrastructure investments. KP's flagship spatial bet is the Rashakai SEZ, which according to the Pakistan Board of Investment is expected to attract US\$2.1 billion in investments and generate over 200,000 jobs, thus ushering a new era in the region's industrial landscape (Xinhua 2021). Its strategic location in the heart of Peshawar Valley indeed offers many advantages: adjacent to the Islamabad-

Peshawar Motorway (M-1), within 90 minutes of two international airports and major dry ports, close to multiple metropolitan areas with large talent pools, and accessible to the Pak-Afghan border cross at Torkham. The newly built motorways and other planned highways have the potential to further enhance benefits of agglomeration while reducing frictions such as time and cost of commuting for workers, and the movement of goods for businesses. Local governments could step up efforts to:

1. Introduce programs for local workforce development in line with expected demands from industry,
2. Review land-use regulations to facilitate new housing construction,
3. Upgrade service delivery units to effectively meet expected demands on services such as water and sanitation

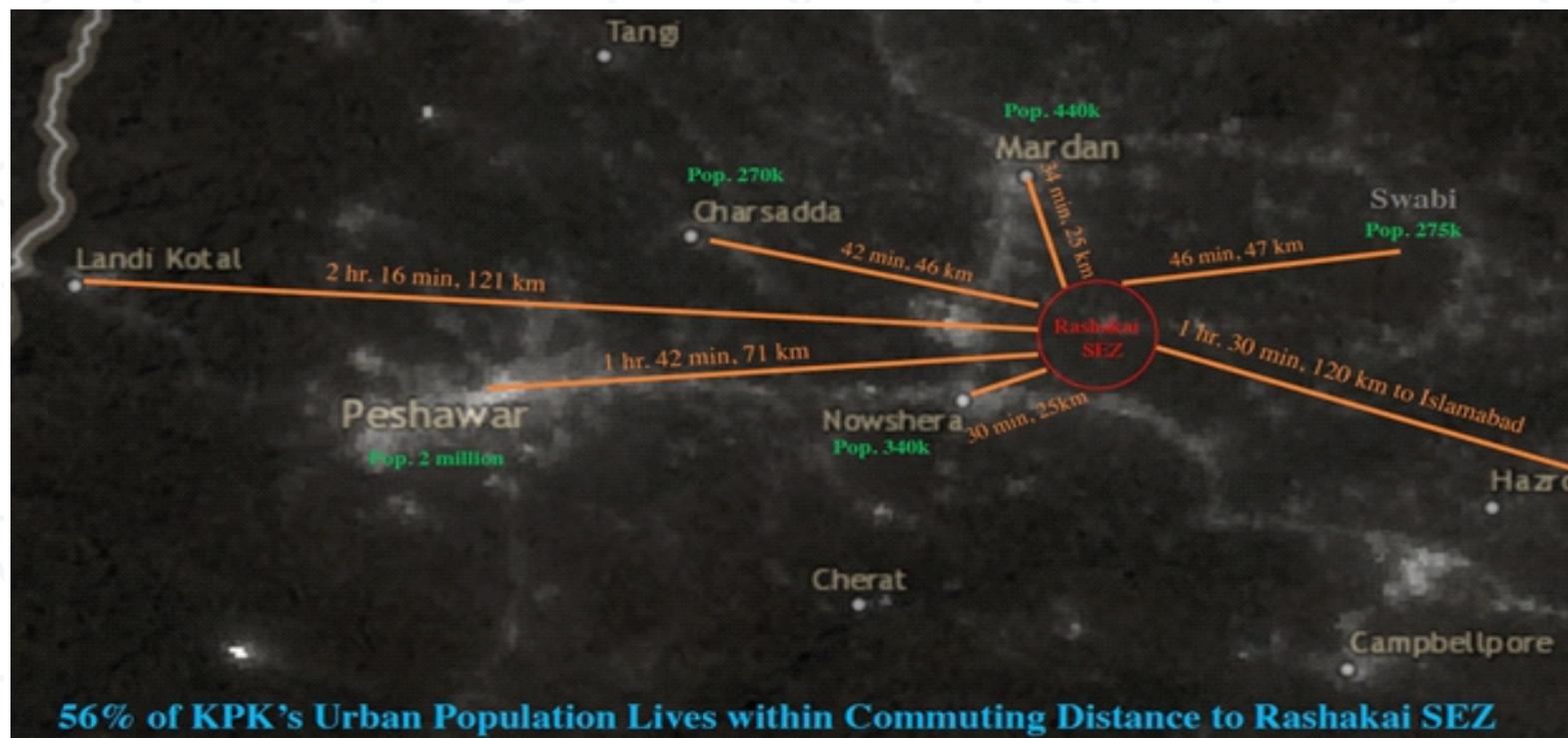


Figure 6: Accessibility and opportunity around Rashakai SEZ

5.2

NEW POLICY COORDINATION MECHANISMS AROUND KEY ECONOMIC DEVELOPMENT OBJECTIVES

Policy Direction

A holistic approach towards strengthening cities as an economic hub must keep in mind the following factors:

a) Government interventions to improve development outcomes should be aligned to the economic potential of each district.

Accomplishing the above objectives will require a clear-eyed view of the vision behind mega projects, both in terms of expected direct and indirect benefits and identifying the binding constraints in the policy environment that must be overcome in order to stimulate urban economies. Because the path from large-scale infrastructure investments to prosperity at the household level requires positive spillovers to accrue to urban centers, policymakers must identify economic competitiveness potential of each district.

b) To achieve the development objectives, municipal finance must be strengthened to generate revenue: Ultimately, the success of

megaprojects will require municipalities to have adequate funding streams to deliver urban amenities needed by businesses and investors to reach international competitiveness. For example, even with world class highway connectivity linking SEZs with dry ports, wholesale markets and international transit trade facilities, trading businesses may not achieve internationally competitive efficiency unless they find and retain skilled workforce that can enjoy high quality urban lifestyle. New methods of own source revenue generation, such as enhancing property tax revenues using technological tools, can be deployed to achieve this objective, provided there is strong buy-in from political leaders to ultimately help shield local land owners' expected pressure against paying up greater taxes. In Somaliland, new revenue sharing models were introduced through which

customs revenues were shared with local governments hosting trade with the expectation that it would help provide complementary services, thus generating win-wins for all.

c) Local economic planning must be improved by strengthening local governance:

For economic policy planning, the multilevel governance system must be reformed such that it moves away from structures dictated by administrative approaches towards functional considerations. As a matter of principle, emerging economic policy needs (rather than administrative legacies or political path dependencies) should serve as the organizing schema for local government.

Specific Initiatives

1. Give recognition to urban centers to improve economic planning:

Instead of allowing only the main Tehsil government of every district to be recognized as “city government,” at least in highly urbanized areas, additional Tehsils can be offered the same status. For example, instead of having only a single city government in every Division's main headquarter Tehsil, at least in leading economic regions slotted for industrialization, other Tehsils with large shares of non-agricultural workers must also be recognized as being urban ([KP Local Government Act 2019](#)). This can provide them access to any special urban development funds and technical assistance for urban public works that can ultimately enable nearby megaprojects to achieve their full economic impact.

2. Improve inter-district coordination around megaprojects:

Similarly, through their Urban Planning Unit (UPU-KP), the provincial government can introduce inter-district coordination bodies organized along functional lines (e.g., Greater Peshawar Valley Authority for Rashakai SEZ) that can together

form spatial-economic plans for their regions keeping in view expected spillovers. Through proper legal mandate and pre-agreement on scope of authority between relevant district, provincial and federal government agencies, these new governance mechanisms can oversee coordinated policy responses to emerging urban service needs. For supporting Rashakai SEZ for example, the Chairperson of the Greater Peshawar Valley Authority can work directly with heads of all district administrations within commuting distance of 90 minutes, provincial line ministries responsible for transportation, investment facilitation and human skills development, and federal agencies like the CPEC Authority or the National Highway Authority to ensure that spatial spillovers are adequately addressed.

3. Strengthen UPU-KP as a technical arm to enhance local economic development planning:

To work effectively, as the chief technical arm on urban policy, UPU-KP must be given the mandate and resources to undertake technical assessments of spatial impacts of megaprojects, determining catch-

ment districts' capacity constraints, and curating development policies between local, provincial and even federal authorities.

For example, if certain district administrations lack GIS knowhow for devising spatial urban plans, the UPU-KP's training and technical troubleshooting arm should be able to plug gaps on short notice. By forging knowledge partnerships with local economic research institutions and mechanisms for continuously engaging with the private sector on key public investment decisions, the UPU-KP must also emerge as the provincial government's primary knowledge hub for documenting and sharing lessons among city governments on best practices focused on local economic development planning. For example, if a new housing program is to be announced by the Naya Pakistan Housing and Development Authority, UPU-KP can serve as the primary provincial government agency providing advisory to the provincial planning and development department for decision making.

5.3

IMPROVING SERVICE DELIVERY AND LAND-USE PLANNING VIA LOCAL GOVERNMENTS

Policy Direction

In the context of ongoing mega projects and social welfare priorities set by the provincial government, improving the state of urban public services is an essential ingredient for stimulating urban economies. To deliver better public services, governments require strong urban economies to provide the revenue base for providing public services. When urban local governments are empowered to raise revenues and charge service delivery fees with the country's multi-level governance system, having higher home values or a high-income population base enables municipalities to raise and reinvest revenues into neighborhoods.

But unfortunately, neither do Pakistan's municipalities have proper fiscal and administrative discretion to do so, nor do the ones needing greater revenue generation improvements have robust economic bases for raising adequate revenues. Cities in KP are expanding

rapidly but are characterized by weak and unequal access to critical municipal and public transport services, driven to a large extent by city governments' weak tax capacity. The inability of city governments to finance municipal services for a growing population is resulting in overcrowding and serious deficits in access to water and sanitation with adverse effects for health and human development.

Decentralization experiences globally have shown that the disempowerment (or non-existence) of elected local governments leads to poorer service delivery and thus worse economic development outcomes (Boex et al. 2016). Throughout its history, successive Pakistani governments have altered the structure of local governments to suit political interests and consolidate power (Cheema et al. 2005). Perhaps paradoxically, non-democratic governments such as those led by Ayub Khan in

the 1960's and Pervez Musharraf in the 2000's have favored decentralization whereas democratic governments have done the opposite. Even though Pakistan's constitution clearly defines local governments as the third tier of the executive branch consisting of elected representatives, the perpetual state of instability and lack of clarity has damaged local government institutions (Kakar 2017). This in turn has deeply impacted provision of urban services.

Furthermore, in many developing cities, poorly designed and unrealistic land use plans have meant that development has proceeded in a largely haphazard way, resulting in urban sprawl and limited provision of necessary public infrastructure. Housing developments in Pakistan, both by individual owners building new homes or expanding existing ones and larger-scale real estate developers building housing societies, simply do not consider the wider adverse impacts of their decisions. When new private developments expand the urban footprint, often into erstwhile peri-urban or rural farmland, they either do so without proper local government approvals or have such a scale that the public service delivery system simply does not have capacity to keep up with demand. At the same time, in most cities across the country, overly restrictive land-use regulations and archaic zoning laws restrict development overall and limit the provision of affordable formal housing. Limited coordination between various government departments involved in planning also results in incoherent and overlapping regulations on land use. For example, in cities like Peshawar today many prime land parcels in the city's central business districts worth millions of

dollars are underutilized for various reasons: colonial era government officers' gated housing enclaves, private membership-based golf clubs, or simply low-density developments despite extremely high market prices of land.

Despite lack of authority, local governments in KP can contribute to economic growth by undertaking smaller steps within their jurisdiction in close coordination with provincial and federal agencies and this is something that the provincial government can explore. They can also contribute by altering local zoning laws and other land-use regulations such that they enable nearby SEZs to achieve their full economic potential. This could entail for instance re-zoning sections of the city as catchment zones for SEZ workers, where high-rise apartment complexes would be permitted in order to support population density necessary to sustain higher levels of public service delivery and urban amenities at par with international standards.

Specific Initiatives

KP's local government system must be reformed based on several principles that have been devised considering international experiences from around the world.

1. Strengthen fiscal position of local governments: The functional responsibilities assigned to local governments (e.g., street cleaning) should match with legal authorities and financial resources necessary to deliver on this.

a. This includes having discretion over raising funds or otherwise undertaking large capital expenses and having discretion over hiring and firing heads of service delivery units responsible for key functions.

b. Local governments must be given adequate fiscal and administrative discretion in terms of setting and collecting user fees or reorganizing service delivery structures, so they do not lose autonomy due to fiscal transfers from higher levels of government.

c. Besides enjoying authority for own-source revenue mobilization, they must also maintain orderly and participatory annual budgeting processes.

2. Give local governments decision-making autonomy: Enabling this political space will ensure they are able to fulfill their mandate of serving constituents and local businesses, which includes service delivery in line with citizen priorities.

a. Elected local leaders must be provided full institutional support from lawmakers and bureaucrats, besides autonomy over making all personnel appointments within functional units.

b. Service delivery units must functionally become part of the local government appar-

atus in terms of appointments, budgets, procurement and capital investment decisions. Because services are often executed at the multi-municipality level due to functional (e.g., water procurement for reservoirs) and economic (e.g., economies of scale) reasons, elected authorities must be given adequate control over their own affairs.

3. Strengthen social compact and quality of service position: Local governments must be required to be fully responsive to citizens by establishing and reporting on performance frameworks that are transparently shared with members of the public. It follows that citizens must have ample opportunities for participation in local planning, budgeting and public spending decision making. On needing strong economies to generate revenues for infrastructure and service delivery – this is a two-way street. While one needs this infrastructure and service delivery to build strong economies, this in turn would also widen and deepen the tax base, starting off a 'virtuous circle' cycle. In fact, the need for robust urban local revenue streams has acquired even more significance today with urban citizens in KP experiencing a disproportionately higher economic shock due to preventive lockdowns introduced during the Covid-19 pandemic in Pakistan.

4. Improve land use policies: Because KP's cities appear to be underutilizing highly productive central urban land parcels for more economically productive uses such as finance or service industry, as part of their local economic growth plans, empowered urban governments could use deregulated land-use policies to stimulate private

investment into real estate development. By having greater knowledge of the local economic and policy environment, including through the involvement of local communities and businesses in new urban land-use regulations, urban governments can be more likely to make welfare enhancing decisions with greater accountability toward citizens' interests. Ultimately, after urban local governments begin delivering on their promises and thus earning greater trust from investors and citizens alike, the entire local government system could likely become its own policy constituency in the political system. Making investments in highways and establishing industrial zones like Rashakai, without serious reform of the local government system, the government may further be incentivizing private companies to start new housing societies to meet housing demand.

5.4

DEVELOPING IDENTITY OF CITIES AS HUBS OF ECONOMIC ACTIVITY AND TRADE

Policy Direction

To stimulate urban economies, the government must provide localized sector support to urban centers by identifying competitive and growing industries, particularly where they are positioned to capitalize on the comparative advantages and providing support for these industries through the range of mechanisms at the disposal of local and provincial governments. The advantage of such a proactive approach is that cities can focus on providing an enabling business ecosystem for industrial growth, by targeting specific economic sectors for economic development initiatives.

The advantages of agglomeration are well-documented. It not only enables matching of firms and workers but also reduces information gaps between buyers and sellers and

encourages technology transfers and spillovers. This allows economic centers to better leverage comparative advantages through economies of scale. However, governments do not always have access to sufficient and frequent data on sector growth or potential and therefore it is essential to ensure that informational challenges are overcome.

Industrial activity in KP is low compared to the main industrial provinces, Punjab and Sindh. KP's geographic location may be an important barrier for industrial development in the province. Its distance to ports imposes high transport costs on (imported) inputs and outputs. These costs reduce the competitiveness of KP's goods and commodities compared to other nations except neighbouring Afghanistan.

Hence, KP government can look into the following aspects of trade:

- a)** Reclaim Peshawar's role as a hub of regional trade and as a commercial center to become a major growth node in the country.
- b)** Focus on trade links with India, China and Central Asia by playing KP's natural role as a connector with the potential rents accruing to the province that can be later invested in building a strong manufacturing and export base for the future.

Specific Initiatives

1. Define a city's economic identity: To attract investment and have the right business environment and investment regulation it is important to understand and define the cities' economic identity and its comparative advantage. This would in turn help identify potential economic sectors for investment which would then need to be embedded within a long-term economic

development plan as well as the need for research/data on key economic sectors in each city/ district. These plans and priorities need to be pro-actively communicated to possible investors to allow and attract investments in sector-specific infrastructure based on investor/ industry demand. These sectoral priorities will also need to interact with broader regional investments like

highways, borders and ports, SEZ's etc. One growth sector for KP can be tourism. Others can include promoting SMEs and manufacturing via SEZs.

KP's Reforms in the Tourism Sector

The Government of KP (GoKP) acknowledges tourism in the province as an important mobilizer of economic growth. The province is home to some of the most popular tourist destinations in Pakistan, including historical sites, mountaineering regions, and adventure sports. The availability of a wide variety of these tourist activities – even if situated in remote parts of the province – offers a great potential for economic activity in neighboring city centers.

In recent years, mainly due to increased security and improved accessibility, tourism in KP has experienced substantial growth with around 1.2 million domestic tourists in addition to thousands of international tourists annually, generating more than \$120 million in direct revenue.

Globally, local establishments and small businesses benefit the most from a tourism-based economy. By fostering these partnerships, the government can achieve higher levels of job creation. Infrastructure in cities also benefit from tourist activities, with investments in roadways, transit, and public services.

The provincial GoKP has periodically increased the budget allocated to tourism, while promoting PPPs on the sidelines. Cities in the province could become major players in this space, both by boosting new investments in cities (hotels, restaurants, malls etc.) and helping boost tourism (improved street cleaning, revival of historic sites, improvement of tourist services). The geography of KP is distinct where it offers many opportunities for seasonal tourism. This can enable specific regions to develop their localized tourism industries, enabling local economic mobilization. As the province strives to develop Integrated Tourism Zones (per the KP Tourism Policy), new opportunities open up for less-developed areas and small cities to experience sustained development and economic growth.

KP now has a tourism policy and in conjunction with the Khyber Pakhtunkhwa Integrated Tourism Development Project (in collaboration with the World Bank), the provincial government plans to support sector based entrepreneurship and infrastructure developed across major tourist destinations across KP, inevitably giving a boost to the cities' local economies.

Source: Khyber Pakhtunkhwa Integrated Tourism Development - Project Environmental and Social Management Framework, Updated With Covid-19 Checklists April 2020

2. Make economic planning a function of local government:

Ultimately, economic development planning must become a salient local government function, with full ownership and accountability in the hands of local authorities through specialized bodies.

- In this model, each municipal and district government can be responsible for undertaking economic sector analysis to identify sectors and industries that offer unique competitive advantages over competing localities along with a clear understanding of how their local economy fits into the overall economic system.
- This would require careful data collection and analysis on the structure of local employment, i.e., numbers and types of occupations and worker profiles, along with deep know-ledge of local industries' value addition into broader economic value chains.

• Economic development departments should thus be setup at the local level, with technical assistance from the UPU-KP and knowledge sharing from research partners that would in turn work with chambers of commerce to understand their businesses.

3. Improve trade facilitation: To make better use of KP's geostrategic location connecting landlocked countries in central Asia, including Afghanistan, cities must step up by enhancing trade facilitation and services. Estimated at over \$1 billion per year, Afghan transit trade going mainly through the Torkham border crossing offers massive untapped potential for all of KP, but particularly for the greater Peshawar area which has high concentration of industries that could benefit from in- and out-flows of trade into neighboring Afghanistan. The benefits of greater trade flows through KP, particularly when combined with value added services such as dry fruit processing, cleaning and packaging could serve as a great source of

revenue for local authorities and jobs for small businesses.

- Improving infrastructure of wholesale markets, storage, and processing services to facilitate a targeted set of commodities in their movement from Central Asia to the rest of the world, through KP and the rest of Pakistan.
- Building capacity of small businesses in KP and training young job seekers to make better use of upcoming opportunities in the form of greater transit trade facilitation. But this ought to be done in a targeted and planned manner based on studies of the entire supply chain of key sectors, and an understanding of the gaps between international demand and local supply.

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