

CHAPTER 1: CHALLENGES AND STRATEGY

1.1 The NWFP is well endowed with natural resources and is home to citizens known for their hard work, sense of honor and dignity. And yet, along with Balochistan the NWFP is the poorest province of Pakistan. Poverty is extensive, and is compounded by frequent natural disasters and health problems. There are too few jobs, and they pay too little. Most workers are self-employed in low-productivity informal activities. Public safety nets are inadequately funded and cover too few of the poor. **The challenge for the NWFP is to break out of these circumstances and to embark on a sustained improvement in the life of its citizens.**

1.2 The challenge has been created by the province's GDP consistently growing more slowly than that required to reduce the incidence of poverty. Between 1990/91³ and 2004/05, the NWFP's real GDP is estimated to have grown at an annual rate of about 4½ percent a year. Given an average population growth of 2.8 percent a year, per capita incomes increased by just 1½ percent annually.

Trends in Consumption, Inequality, and Poverty in the NWFP

1.3 The evidence on poverty and its correlates is largely drawn from Pakistan Integrated Household Survey (PIHS) data for different years (1998/99 and 2002); and poverty trends over a longer period have been constructed using a series of Household Income and Expenditure Survey (HIES) from the 1990s using poverty lines that represent a constant level of welfare over time.

1.4 It is important to clarify that the poverty estimates presented here are not official, but derive from World Bank staff's calculations using three HIES rounds during the 1990s and PIHS rounds of 1998/99 and 2001/02.⁴ The estimates are founded on a standard methodology and provide a consistent measure based on a poverty line held constant in real terms from the early 1990s to 2001/02, the latest year for which data are available.

1.5 The main messages from the analysis can be summarized as follows.

A. THE POVERTY CHALLENGE

1.6 **Using the Basic Needs poverty line described above, the poverty headcount for the NWFP increased between 1990/91 and 2001/02** (Figure 1.1). In 1990/91, an estimated 37 percent of the population belonged to households that were below the poverty line; in 2001/02 the figure was virtually the same, at 35 percent. However, because the population had increased substantially, the actual numbers of the poor were higher in the latter year.

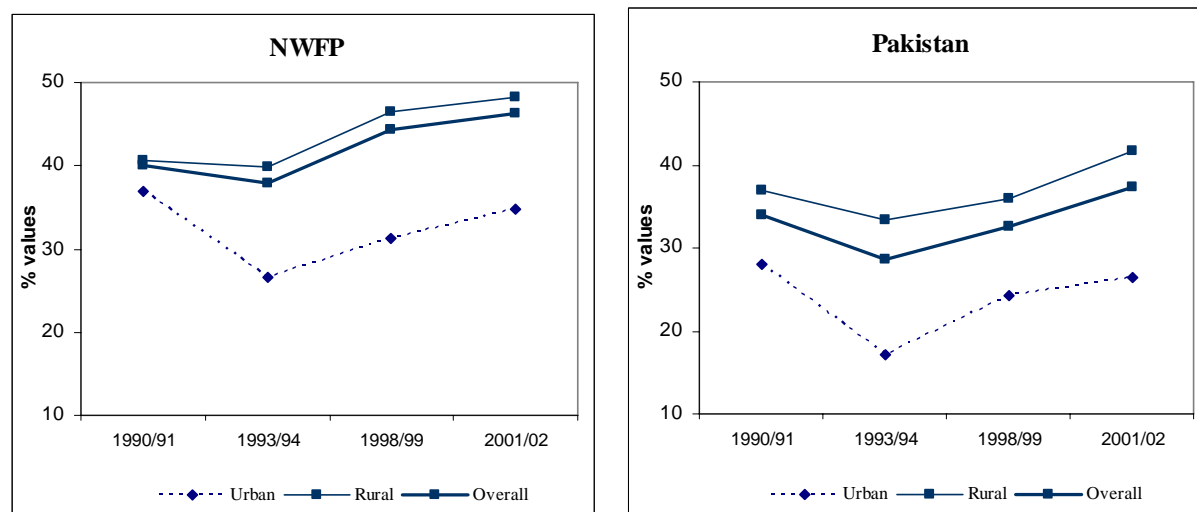
1.7 While urban poverty declined marginally (by about 2 percentage points), rural poverty registered a sharp increase (of almost 8 percentage points), significantly widening the rural-urban gap over the decade. Both rural and urban poverty appear to have declined during the first part of the decade, and risen

³ Fiscal year and national accounts year run from July 1 to June 30; e.g., FY04 = July 1, 2003 to June 30, 2004. This report refers to a FY, say that ending in June 2004, as FY04 or 2003/04.

⁴ The unofficial Basic Needs poverty line (developed by World Bank) used here amount to Rs 680 and Rs 767 for rural and urban areas respectively per equivalent adult per month (at constant 1998/99 Rs). Recently, the government of Pakistan has adopted an official poverty line, the rupee value of which (Rs 674 per month per equivalent adult male in 1998/99 Rs) is arrived at by estimating an expenditure level that is required to attain a minimum threshold of calorie consumption (2350 calories per equivalent adult per day). However, a few methodological issues surrounding the measurement of poverty using this line remain to be settled, and there is no consensus yet on the provincial poverty estimates (the government's PRSP (published in 2004) contains no province level estimates of poverty incidence).

during the later part. The increase in poverty that occurred between 1993/94 and 1998/99 continued until 2001/02 — the last year for which data are available.

Figure 1.1: Poverty Trends in the NWFP and Pakistan (World Bank Poverty Lines)



Source: HIES/PIHS.

1.8 Throughout 1990/91 to 2001/02, levels of poverty in the NWFP remained persistently higher than for the country as a whole, in both urban and rural areas — the NWFP remained the poorest of the larger provinces of Pakistan (Table 1.1). The trends in poverty headcounts for the NWFP largely mirror the trends for the country, suggesting that macroeconomic factors that affect poverty levels all over Pakistan also play a large role for poverty in the NWFP. In spite of some convergence in recent years with the rest of the country, the poverty challenge in the NWFP remains considerable — in absolute terms as well as relative to the rest of the country.

**Table 1.1: Poverty Trends in the Larger Provinces (World Bank Poverty Line)
(Percent of Population)**

Provinces	Urban				Rural				Overall			
	1990/91	1993/94	1998/99	2001/02	1990/91	1993/94	1998/99	2001/02	1990/91	1993/94	1998/99	2001/02
The Punjab	29	18	27	27	39	32	35	37	36	28	32	34
Sindh	24	14	19	24	31	32	37	51	28	23	29	40
The NWFP	37	27	31	35	41	40	47	48	40	38	44	46

Source: World Bank 2002b, Annex.

1.9 In the NWFP, poverty in the rural areas is significantly worse than in the urban. In 2001/02, about 48 percent of the population in rural areas belonged to households below the World Bank poverty line, compared with 35 percent in urban areas. This disparity continues to stimulate migration to urban areas, as well as to regions outside the province.

1.10 A large proportion of the NWFP's population is concentrated around the poverty line. In 2001/02 about 57 percent of the province's population was situated in a small range of between 0.75 and 1.25 times the World Bank/Basic Needs poverty line. This clustering means that relatively small increases in income can lift substantial numbers of persons above the poverty line, or drop them below it if incomes fall.

1.11 **Inequality in consumption declined in recent years but remained greater in urban than in rural areas.** Inequality in consumption declined between 1998/99 and 2001/02 as measured by the Gini index that fell from 0.28 to 0.24. Poverty increased, but the poorest groups registered some gains. Consumption inequality in the urban areas was greater than in the rural. Between 1998/99 and 2001/02 consumption inequality declined in both areas, with a somewhat larger decline in the urban areas. Extreme poverty accounts for a relatively small share of the poor. About 13 percent were individuals with consumption below 75 percent of the poverty line.

1.12 **The main constraint on reducing poverty in the NWFP in the years up to 2001/02 was lack of economic growth, in both rural and urban areas.** An instructive illustration of the importance of economic growth is provided by the period between 1998/99 and 2001/02. Even though the distribution of consumption improved during these years and resulted in a small drop in the depth and severity of poverty, the decline in per capita expenditure implied that, on balance, no gains were made in terms of reducing the proportion of the population below the poverty line.

The Correlates of Poverty: What Characterizes the Poor?

1.13 Examining the correlates of consumption poverty serves the dual purpose of understanding the multi-dimensional nature of poverty — beyond deprivation in consumption alone — and identifying the characteristics that perpetuate the cycle of low earning potential and low capability. The most important correlates examined are the following.

1.14 **Lack of ownership of agricultural land is closely associated with poverty in rural areas.** The incidence of poverty declined sharply for households owning 1 hectare of land or more, falling to almost zero for households with more than 4 hectares. While individuals with no land constitute about 58 percent of the rural population, they account for about 70 percent of the population in the poorest quintile.

1.15 **Paucity of jobs and poor pay constitute an important correlate of poverty in urban areas.** This is discussed further below.

Poverty and Human Development

1.16 The modern view of poverty regards it not simply as a shortfall in income or consumption, but rather as a deprivation of those capabilities that enable an individual to pursue a life that s/he considers worthwhile. Poverty is thus also characterized by low levels of human capability, manifested, for example, by lack of education or poor health.

1.17 **The province's achievements in education and health are below the national average.** The literacy rate (10 years and older) in the NWFP was 38 percent in 2001/02 compared to 45 percent for Pakistan. Nearly 58 percent of households in the NWFP had access to safe water (Pakistan: 86 percent). The contraceptive prevalence rate is 30 percent compared to 32 percent for Pakistan and far below the rates for India and Bangladesh.

1.18 **The education level of the household head and the incidence of poverty are strongly correlated.** Poverty declines with higher levels of education. About 30 percent of individuals living in households whose head has never been to school belong to the bottom quintile; this falls to 20 percent when he/she has finished school. Households whose head has never attended school constitute 62 percent of the population of the NWFP, but account for 71 percent of the bottom quintile; whereas households whose head has had education of matriculation level or above constitute 16 percent of the population but 11 percent of the poorest quintile.

1.19 Since education is strongly correlated with income and economic status later in life, *the education attainment of children is a critical indicator for households' future ability to climb out of poverty*. In this context, the wide rich-poor gaps seen in school enrolments for the NWFP are a significant source of concern. In 2001/02, there was a gap of 38 percentage points in primary Gross Enrolment Rate (GER) and 50 percentage points for secondary GER between the top and bottom quintiles. A significant rich-poor divide also exists in terms of where children are enrolled: private schools account for 13 percent of primary enrolment, but 43 percent of the enrolment of the 5th quintile and just 3 percent for that of the 1st quintile. The poor thus rely overwhelmingly on public education, which brings into sharp focus the need for quality public schooling to improve education attainment among poor children.

1.20 **Poverty is also strongly associated with lack of access to critical health services and poor health outcomes.** In 2001/02 for instance, pre-natal consultation rate was 15 percent in 2001/02 for the bottom quintile and 43 percent for the top quintile; and 20 percent in rural areas compared to 36 percent in urban areas. Qualitative evidence suggests health shocks are an important cause of poverty; moreover, since the poor often do not seek or receive treatment for their health issues, it is not uncommon for relatively minor conditions to escalate into chronic, debilitating major problems of serious consequences.

1.21 **Access to safe drinking water and sanitation are important determinants of health, and a strong association between these indicators and consumption poverty indicates the health challenges faced by poor households.** In 2001/02, about 51 percent of households in the bottom quintile relied on potentially unsafe open sources for drinking water, 68 percent had no access to drains and 34 percent did not have toilet facilities inside their homes. These proportions fell progressively for higher quintiles, to 18, 43 and 9 percent respectively for the top quintile.

1.22 **Poverty is commonly associated with a lack of voice in influencing decisions at community and policy making levels.** In the Pakistan Poverty Assessment for the NWFP⁵, lack of empowerment was articulated as a fundamental experience of the poor in all spheres of their social, cultural and economic lives.

B. THE EMPLOYMENT CHALLENGE

1.23 While macroeconomic growth is a must for reducing poverty, its impact on poverty is critically affected by conditions in the labor market. In order to be pro-poor, growth must generate employment and gains in productivity that lead to rising wages, particularly in sectors in which the poor are more likely to be engaged. The analysis of labor markets in the NWFP thus focuses on the quartet of labor participation, employment, productivity, and earnings. It will be seen that an important part of the challenge of alleviating poverty in the NWFP involves the development of a modern labor force in the province.

1.24 **The open unemployment rate of 13 percent of the labor force in the NWFP in 2001/02 was the highest of any province of Pakistan.** In addition, the labor force contains a very substantial number of underemployed workers (defined as "employed, but available for more work and actively looking for more jobs"). In 2001/02, the combined unemployment and underemployment rate amounted to nearly 15 percent of the province's labor force.

⁵ Part of the Pakistan Poverty Assessment (PPA), 2002.

**Table 1.2: Composition of Employment, 2001/02
(Percent)**

	Male	Female	Total
Urban	15.2	1.2	16.4
Rural	77.2	6.3	83.6
Total	92.5	7.5	100.0

Source: Labor Force Survey (LFS), 2001/02.

1.25 **The bulk of employment in the NWFP is rural, self-employed in family businesses, and male. Paid employment is very scarce and regular "salaried" jobs even more so.** This emerges as a key causal factor behind high poverty.

1.26 More than three-quarters of the NWFP's workers are males employed in rural areas. Sixteen percent of workers are in urban areas; only 7.5 percent of the work force is female. The vast majority of workers in the NWFP (92 percent of males and 83 percent of women) work in enterprises containing 5 or fewer workers; only 1 percent of workers are in firms with more than 20 workers. Only 18 and 21 percent of male and female workers, respectively, are salaried; the rest are either self-employed (62 or 72 percent of men and women, respectively), or casually employed.

1.27 **With low and falling participation rates and rising unemployment, the employment challenge is growing.** Labor participation rates in the NWFP are substantially lower than in the rest of Pakistan and even these low rates declined between 1993/94 and 2001/02. The combination of low participation rates and rising unemployment means that the magnitude of the employment challenge has increased over time: in 2001/02 less than 40 percent of adults in the NWFP were employed, compared with more than 45 percent in 1993/94.

1.28 **The labor force in the NWFP is less educated than in the rest of Pakistan.** While low educational outcomes are a common phenomenon across Pakistan, the NWFP fares particularly badly. It is estimated that 51 percent of the workforce in the NWFP has no formal education, compared with about 46 percent in the rest of Pakistan. This is likely to have a serious adverse effect on the labor force's productivity in the NWFP.

1.29 **Average job earnings in the NWFP for male workers are lower than in the other provinces of Pakistan.** This can be seen from Table 1.3, which compares the job earnings of workers in salaried or casual employment.⁶ Average annual earnings in the NWFP are Rs 40,000 per year, corresponding to US\$700 at current exchange rates. Men in the NWFP earn on average 30 percent more than women.

**Table 1.3: Average Earnings by Province, 2001/02
(Rs Per Year, Current Prices)**

	Male	Female	Total
Punjab	41,051	21,758	37,408
Sindh	55,609	47,234	55,115
NWFP	40,849	31,351	40,325
Balochistan	42,172	40,834	42,134
Total	45,039	25,064	42,316

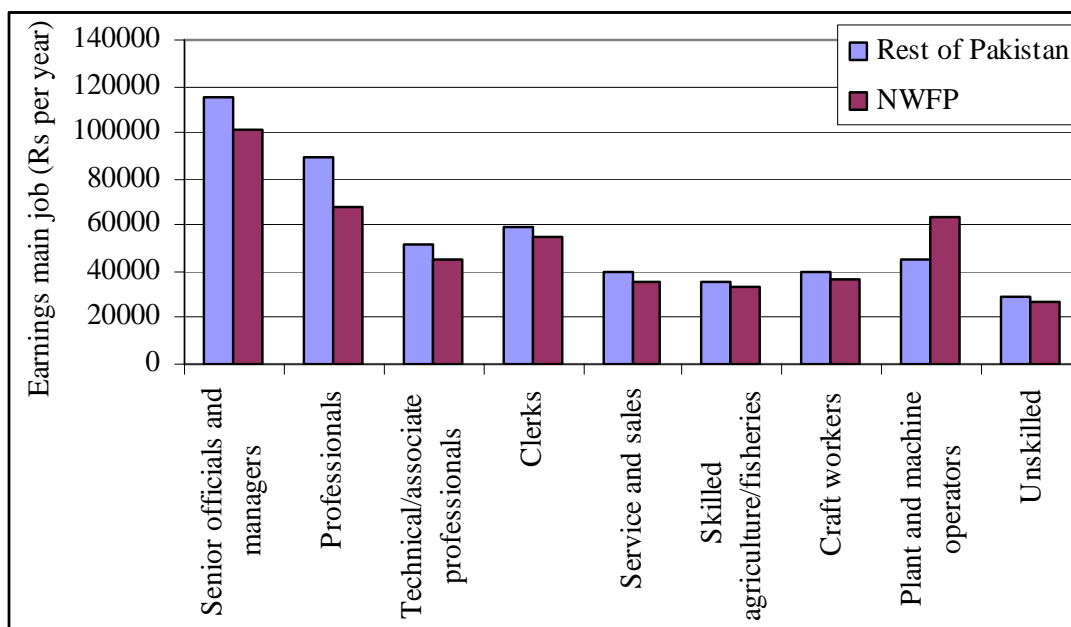
Source: LFS, 2001/02.

⁶ No information is available from the Labor Force Survey on the earnings of the self-employed.

1.30 **Average real earnings in the NWFP declined between 1993/94 and 2001/02.** Correcting job earnings for price inflation reveals a decline in average real earnings in the NWFP of 4 percent over the period 1993/94 to 2001/02. This decline is equal for men and women and is comparable to the development in labor markets in the rest of the country. It means that already low earnings gradually were eroded during much of the 1990s while consumption poverty was on the rise. The decline in real earnings was more severe in the rural than in the urban sector.

1.31 **The reason for lower-than-national-average earnings in the NWFP is to be found in lower earnings for any given job.** Figure 1.2 shows that most professions earn less in the NWFP than elsewhere in Pakistan.

Figure 1.2: Average Earnings by Profession in NWFP and Rest of Pakistan, 2001/02 (Rs Per Year, Current Prices)



Source: LFS, 2001/02

Given that earnings generally reflect productivity, this suggests that productivity in the NWFP in a given profession is below the national average. The low level of education of the NWFP's labor force obviously contributes to low productivity and earnings. Further analyses also show that for women, returns to education appear to be substantially lower in the NWFP compared with the rest of Pakistan. For the NWFP's male workers, returns to education are only slightly lower than for Pakistan as a whole.

C. REMITTANCES AS AN OPPORTUNITY

1.32 Remittances play a vital role in the economy of the NWFP. There is a long tradition of workers from the NWFP migrating to other parts of Pakistan or overseas searching for work. This migration is largely caused by the absence of employment opportunities in the province. The money remitted by these workers contributes in a significant manner to household income, consumption, and investment. Almost 30 percent of households in the NWFP receive remittances from someone in Pakistan, while 8 percent receive from workers overseas, often in the Gulf; these shares are double the national average. Transfers are substantial: average annual transfers (for those that receive them) are Rs 30,000 for domestic and Rs 71,000 for international remittances. When these transfers are averaged over all households in the NWFP

(receivers and non-receivers), they constitute Rs 15,000 per year per household, corresponding to 18 percent of annual household consumption.

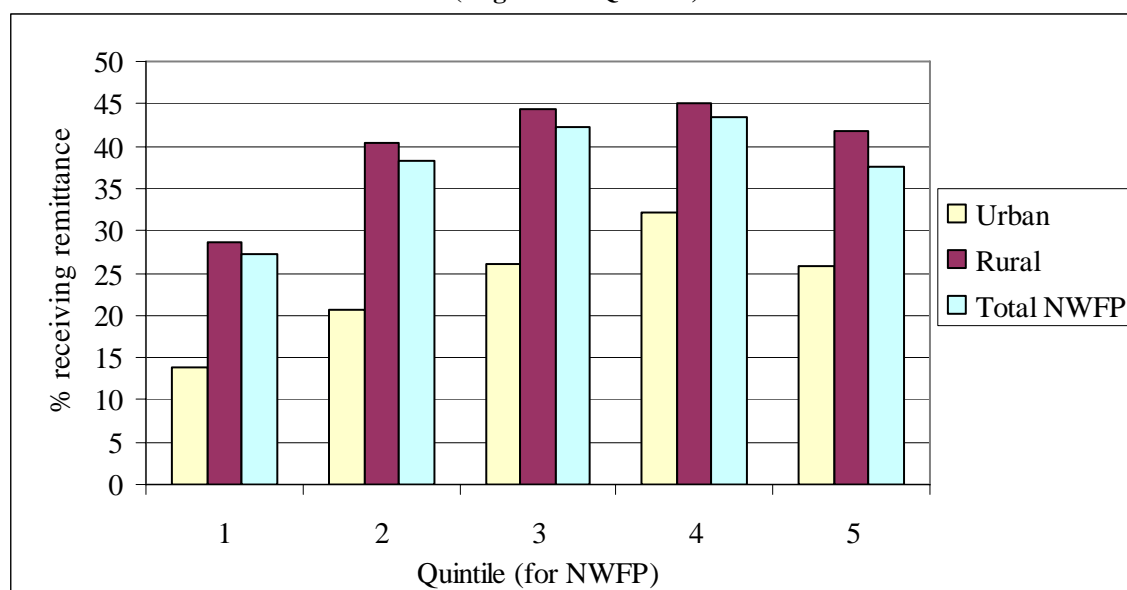
Table 1.4: Remittances in the NWFP and Pakistan, 2001/02
(Rs and Percent)

	NWFP	Pakistan
Average domestic remittance (all households (HHs))	9,039	3,989
Average international remittance (all households)	6,015	2,998
Average domestic remittance for receivers	30,410	29,135
Average international remittance for receivers	71,215	72,859
Share receiving domestic remittances (%)	29.7	13.7
Share receiving remittances from abroad (%)	8.4	4.1
Average domestic remittance (all HHs) as % of HH expenditures	11.2	4.6
Average international remittance (all HHs) as % of HH expenditures	7.4	3.4
Average domestic remittance for receivers as % of HH expenditures	37.7	33.3
Average international remittance for receivers as % of HH expenditures	88.2	83.3

Source: PIHS 2001/02.

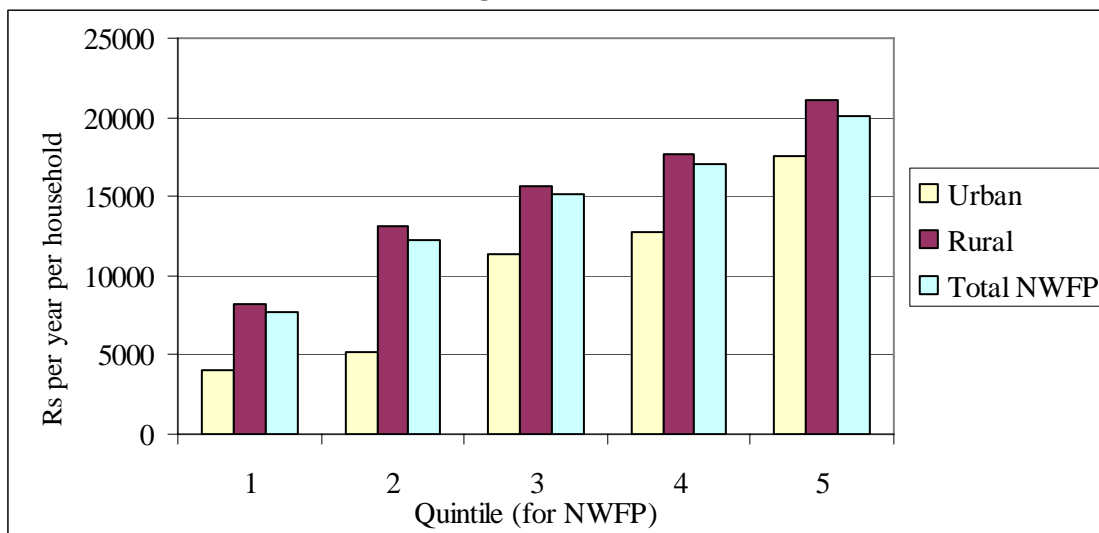
1.33 Rural households are more likely to receive remittances and receive larger amounts on average than urban households, reflecting a rural tradition for migrating out of the province. As can be seen from Figures 1.3 and 1.4, households in the upper quintiles are normally more likely to receive remittances, and on average receive larger money amounts, than poorer households; of course, to some extent households become better-off as a result of remittances. However, it should be emphasized that remittances tend to make the income distribution more, not less, unequal. The fact that the NWFP has a strong tradition for remittances thus does not remove the need for safety nets and other poverty-targeted interventions.

Figure 1.3: Share of NWFP's Population Receiving Remittances, 2000/01
(Region and Quintile)



Source, PIHS 2001/02.

**Figure 1.4: Average Amount Received in Remittances in the NWFP, 2000/01
(Region and Quintile)**



Note: Average is for all households, including both receivers and non-receivers.

Source: PIHS 2001/02.

1.34 From the available data, it is hard to say much about the use to which remittances are put by the receivers. In all likelihood, remittances contribute to higher consumption and benefit the development of the province through multiplier effects and other links. PIHS data shows that school enrolment rates for children from households in the NWFP that receive remittances are larger than for those households that do not receive them (by some 5 percentage points). This difference in schooling investments, which is larger in rural than in urban areas, is also found when comparison is made quintile-for-quintile and thus does not merely reflect an income effect. It suggests remittances contribute to higher human capital among recipients, possibly encouraged by the relatively stable nature of remittance income or by the closer contact with out-of-province labor markets in which returns to schooling may well be higher than in the NWFP itself. Another use of remittances is larger and better houses. Data from the PIHS suggest that households receiving remittances have larger houses than households that do not receive remittances (this difference is also found when comparison is made quintile-for-quintile).

D. A STRATEGY TO MEET THE POVERTY AND EMPLOYMENT CHALLENGES

1.35 The previous sections outlined the dimensions of the challenge of alleviating poverty in the NWFP, and identified the creation of productive employment as the main element of the solution.

1.36 How can more jobs be created? The creation of employment requires an increase in the demand for labor, and this generally comes about with an expansion of the GDP. How much faster should the GDP of the NWFP grow in order to absorb the additions to labor force and to make a dent in the ranks of the previously unemployed? The long-term elasticity of employment with respect to real GDP growth works out to approximately 0.55. The labor force is presently growing at about 3.2 percent a year, so this implies a growth rate of 6 percent a year for the real GDP to absorb the additional workers entering the labor force. However, the real GDP growth rate will have to be higher in order to provide employment to

workers who are in the labor force but are at present unemployed. Thus, a target growth rate for the province will probably have to be 7 – 7.5 percent a year in real terms.⁷

1.37 What can be regarded as the potential growth rate for the NWFP? The estimation of a potential growth rate can be approached in a number of ways. First, the potential growth of GDP is the sum of the growth of the labor force and of labor productivity. The labor force is currently growing at about 3.2 percent a year. Unfortunately, the available data on employment raise serious questions and make calculations of labor productivity extremely problematical. Some *very* rough calculations and evidence from other countries suggests that a likely rate for the growth of labor productivity could be in the range of 1.5-2.0 percent a year. Second, the poor quality of the data makes it pointless to use any serious econometric technique to factor out short-term fluctuations and arrive at the underlying trend. Third, one may regard the real growth attained by the province over a long period as a proxy for the potential growth rate. Over the last 14 years (FY91 – FY05), the GDP of the NWFP grew at a rate of 4.6 percent a year; in the last 7 years the growth rate averaged 4.4 percent. Thus, whichever number one picks, it is clear that the potential rate, given the NWFP's *existing institutional and technological base*, is insufficient to attain the government's objectives. This means that a priority for the authorities must be to strengthen the institutional base and to upgrade technologies in the province.

1.38 What would be the main elements in a development strategy for the NWFP that sought to attain such a growth rate? The steadily increasing pressure on the cultivable land requires the NWFP to develop policies that would maximize returns from the cultivable area and at the same time emphasize activities that are not intensive in the use of cultivable land. The same pressure increases migration from the rural to the urban areas, which creates its own set of problems and opportunities. The problems, of course, arise from the concentration of population in urban areas, which requires the provision of jobs and an expansion of services. The opportunities reflect the other side of the same coin. The concentration of skills and the enlargement of the market in urban areas offer the prospect of reaping the benefits of specialization and the division of labor, and hold out the possibility of the urban centers' acting as engines of growth.

1.39 In broad terms, this means that the strategy for the NWFP would be to enlarge the cultivable area by expanding the irrigation network, while also moving the agricultural sector increasingly towards higher value crops, such as horticulture. Outside agriculture, the strategy would be to develop those activities in which the province is likely to have a comparative advantage. A broad range of activities could meet this criterion.

1.40 In manufacturing, the province is likely to possess a healthy comparative advantage in the extraction and polishing of marble, of gemstones, and of construction materials for export to Afghanistan. The province also possesses a strong comparative advantage in the generation of electricity from hydel sources. If this power could be made available to local industry at prices lower than those charged by the National Grid, it is likely that some other manufacturing activities could also become competitive. We return to this point later in the report.

⁷ There are no official GDP figures for the NWFP. The estimates presented in this report have been prepared by World Bank staff and represent only a first approximation. The figures are based, as far as possible, on the methodology used by the Federal Bureau of Statistics for estimating the national GDP series and are consistent with the estimates for the Punjab and Sindh in the World Bank's economic reports for those provinces. The procedures underlying the Bank's estimates for the NWFP are described in an appendix to this report. It is hoped that the NWFP government will issue a more refined and official set of calculations that could be used in subsequent work.

1.41 Another potential sector for generating incomes is tourism. It is apparent that tourism assets — such as high mountains, scenic valleys, exotic cultures, historic sites — abound in the province. However, under the existing law and order conditions (and perceptions), it is unlikely that foreign tourism would play a significant part; such possibilities as exist, therefore, must come from domestic tourism. But questions remain of the extent of the domestic demand to visit these assets, and the costs of providing safe and convenient access. While tourism must undoubtedly figure as an element in the long-term development of the province, its role in the immediate future requires further investigation.

1.42 An area that appears to offer considerable possibilities is the generation of hydel power. The NWFP currently generates 3,767 megawatts but these are sold to WAPDA which then sells them to consumers (including in the NWFP) at a higher price. But sale to WAPDA is not the only option available to the province. It is possible to establish (small) units that provide so-called “captive” power at a price different from that charged by WAPDA. Representatives of the private sector argued that if this power were priced less than that charged by WAPDA, for a number of industries it would offset the higher transport charges occasioned by the province’s distance from seaports. Expanded generation of hydel power, therefore, could provide resources to the government both directly by sale to WAPDA, and indirectly by giving a fillip to industry in the province, which would lead to greater employment and thus to higher incomes and tax revenues.

1.43 In developing a growth strategy for the NWFP, it is important to emphasize that the main thrust must come from the private sector. This is necessary both in order to ensure greater efficiency by stimulating competition and thereby encouraging firms to move to the "best practice" technological frontier, and also because the provincial budget cannot bear the strain of continually financing loss-making activities in the public sector. However, the organized private sector in the NWFP is small. A crucial element in the development strategy, therefore, is the expansion of the private sector. This, in turn, will require improvements in the working of various institutions, particularly the bureaucracy, the commercial judicial system, the taxation system, the financial sector, and the systems of education and labor training.

1.44 Recent developments in international affairs should encourage the NWFP to "think outside the box" in formulating a development strategy. The most important development has been the end of hostilities in Afghanistan and the commencement of a vigorous reconstruction program in that country. As a result of history and culture, the NWFP is well placed to participate in this rebuilding effort through the export both of commodities and of skills. An important part of the province's development strategy, therefore, should be to encourage activities that would take advantage of the NWFP's links with Afghanistan. Official trade between the NWFP and Afghanistan is already increasing quite rapidly — the estimates for 2002/03 put exports from the NWFP at US\$ 125 million, but this is almost certainly an underestimate. There has historically been significant informal trade between Afghanistan and NWFP, in the form of re-exports from Afghanistan and leakage from the Afghan Transit Trade (ATT) facility provided to land-locked Afghanistan by Pakistan. The informal trade (including ATT) was estimated to be close to US\$ one billion in 2000.⁸ Current indications are that the informal trade may have increased after 9/11 (2001). There has been a 17 percent average annual increase in ATT (from US\$220 million in FY02 to US\$370 million in FY05 (preliminary estimates)) of which about 85-90 percent leaks back into Pakistan as unofficial re-exports. Unofficial cross-border trade between Afghanistan and Pakistan is even higher. Although reliable figures are hard to come by in this field, an attempt at assessing the dimensions of the NWFP-Afghanistan trade is made in the chapter on private sector development.

⁸ The World Bank and UNDP, “Afghanistan’s International Trade Relations with Neighboring Countries”, a report prepared under the Afghanistan Watching Brief project, 2001.

1.45 There has been considerable attention in recent years to develop the Federally Administered Tribal Areas (FATA) bordering the NWFP and Afghanistan, which could have positive spillover effects in NWFP. FATA (particularly South Waziristan) has made headlines because of military action since 2004 against alleged Al Qaeda terrorist and training camps. The seven FATA agencies⁹ and 6 frontier regions (FR)¹⁰ are administered by the Federal Government and the NWFP Governor. FATA comprises approximately 2 percent of Pakistan's population and is considered one of the poorest (60 percent of the population is below the poverty line according to the FATA Secretariat's estimates) and least economically developed parts of Pakistan. The economy is largely pastoral with some agriculture in the region's few fertile valleys. Historically, these areas were a major center of opium production but the opium cultivation and trade has been much reduced over the years. Due to its special status and also because of limited employment options, FATA has been a major conduit of the smuggling via Afghanistan. To reduce the influence of terrorist organizations and illegal activities (drugs, arms, smuggling) and to eventually mainstream FATA with the rest of Pakistan, there has been considerable focus on economic development in FATA in recent years. The FATA development budget which stood at Rs 1.1 billion in FY02 increased to Rs 5 billion in FY05 and is expected to increase to Rs 45 billion over the FY05-10 period. The focus is on building roads, water conservation resources, irrigation channels, and provision of social services and reducing gender disparities. These positive developments in FATA are likely to reduce pressures on social services in NWFP. It would provide job opportunities for residents of the NWFP in tribal areas, thus reversing the labor migration from FATA into NWFP. Economic development leading to an improved law and order situation in FATA would help in further improving the investment climate in the province.

1.46 The concentration on mining, manufacturing, hydel power generation, tourism, and so on should not blind one to the fact that agriculture will remain the backbone of the economy. However, in the future agriculture will have to diverge from many of its traditional activities, such as cereal production, and move increasingly towards activities, for example horticulture and livestock, in which the returns are higher.

1.47 The public safety nets available to the poor in the NWFP are the same as elsewhere in Pakistan and are plagued by similar issues of under-funding and under coverage of the poor. Big gaps in the mix of safety net programs include the lack of programs designed to help build human capital of the poor, and the lack of workfare programs for the working-age poor. Therefore, as part of an expanding anti-poverty strategy, the NWFP could consider piloting demand-side interventions to promote better health and education outcomes among the poor, using conditional transfers or school feeding programs, or both. Labor intensive public works could also be considered to help provide employment and income to poor and underemployed rural workers; such programs also help build and maintain essential rural infrastructure that can play a role in reducing poverty and vulnerability. Moreover, it would seem appropriate to review the disaster prevention, mitigation, and management capacity of the province, to ensure disaster management programs are in place.

1.48 The provincial development strategy will be shaped by constraints, such as an inadequate infrastructure or limited financial resources, which are generic to the country as a whole. But in addition it will have to deal with constraints and characteristics that are either specific to the NWFP or that apply to that province with special force. The following merit special mention.

⁹ The agencies are: Khyber, Kurrum, Bajur, Mohmand, Orakzai, North Waziristan and South Waziristan.

¹⁰ FR Kohat, FR Peshawar, FR Bannu, FR Lakki, FR Tank and FR D. I. Khan.

- ***Distance from seaports:*** The deep inland location of the NWFP means that the cost of imported inputs for the province's productive activities is significantly higher than for those in the other provinces, and that exports from the province (except to immediately neighboring countries, such as Afghanistan) are also correspondingly more expensive. Thus, in the absence of some strong offsetting factors, the province's competitive edge is blunted. It also suggests that the province's industrial strategy will more or less be compelled to concentrate on products that use large amounts of raw materials that are indigenous to the province, that are light-weight and high-value, or that can be exported to countries that are physically closer to the NWFP than to the other provinces of Pakistan.
- ***The effects of being a front-line state.*** The NWFP served as a front-line state and acted as a host to more than three million refugees during the eleven-year war in Afghanistan and also for the period of the civil war that followed. According to a recent survey, there are still 1.9 million Afghan refugees living in the NWFP (approximately 9 percent of NWFP's population). The bulk of them are "old" refugees who have been in the NWFP for twenty years or more and have assimilated well in the province. There have been both positive and negative effects of hosting a large refugee population in NWFP. During the 1980s and early-1990s the flow of foreign assistance and Government of Pakistan's development programs helped the local economy by building infrastructure such as roads, irrigation channels, and was also spent on housing, schools and health facilities for the Afghan refugees. Cheap labor provided by Afghan refugees was instrumental in reducing labor costs in general, and particularly in the transport, construction and agro-based industries. Refugee assistance started petering out by the mid-1990s with the rise of the Taliban in Afghanistan. On the negative side, the two principal long-term consequences were that: (a) the resulting instability discouraged private investment; and (b) the economic and social infrastructure of the province was seriously overused and run down.
- ***Remittances as social safety net.*** As noted above, it is considerably more common in the NWFP than other provinces that households receive remittances from family members working in other parts of Pakistan or in foreign countries. These flows of income play a significant role in alleviating poverty in the province. However, a sustainable development strategy cannot be based simply on the export of labor, if for no other reason than that such a policy is vulnerable to actions by governments over which the NWFP has little influence, and it leads to a continuing hemorrhage of skills that are required within the province for its development. A more stable development strategy, therefore, would be to maintain the flow of remittances, while at the same time enlarging and strengthening economic activities within the NWFP that would generate incomes in a more stable manner and at the same time make available the labor skills to the province. In order to maintain or even increase the returns from migration the strategy would have these policy implications.

Education policy will need to consider the skills required in labor markets outside the NWFP and even outside Pakistan. Workers with higher and technical educations are likely to be in strong demand, as are workers with vocational training. Policy makers should also recognize the fact that to the extent workers migrate out of the NWFP and earn more than workers who remain in the province, analysis based on returns to education inside the NWFP would underestimate the true expected returns to education.

It would be useful to formulate a strategy for skills improvement of potential migrant workers, and to find ways to maximize the benefits to the province of its migrant workers; these benefits include remittances, investment, and occasionally return migrants bringing skills and capital acquired elsewhere. The key to maximizing benefits from this large group of people will be to

maintain contact and links and encourage flows of people, information, and money between the province and the places of residence of the migrants.

- ***The treatment of hydel power.*** A problem with analyzing the growth potential of provinces is that the ability to develop their natural resources might be restricted by powers that are legally allocated to a central authority. To an extent, therefore, a province might not be master of its own development fate. While the constitutional allocation of powers between the center and the provinces regarding natural resource development is uniform between all provinces, the impact of such legislation on small provinces with a narrow resource base can be much stronger than on larger regions.

The chief resource of the NWFP is the potential for generating hydroelectricity. Under the rules of business of the Government of Pakistan, power plants above a certain size fall under the purview of WAPDA and all tariffs are determined by NEPRA. Thus, decisions regarding the development of hydroelectric resources, investment in these facilities, and the pricing of electricity are taken by the central government, even though these matters impact crucially on the province's main resource. The province has two broad possibilities for converting its hydroelectric potential into higher incomes. First, the province can earn revenue by selling electricity to WAPDA. Second, it can set up hydel plants with a capacity below 50MW that, while covering their costs, could sell power within the NWFP at a lower rate — subject to NEPRA's tariff determination — than the power provided by WAPDA on the national grid. The lower price for electricity could help to offset some of the transport cost disadvantages arising from the province's geographical location.

1.49 In the last few years a number of important changes have taken place in the political and administrative structures of the provinces. The most far-reaching of such changes is the devolution of power to the districts and local governments. These agencies play a vital role in the delivery of essential services, and are closest to the final consumer of such services. It is therefore necessary to examine how the devolution of power in the NWFP is working in practice, how the devolution affects, for better or for ill, the delivery of services, and how this performance can be improved.

1.50 Finally, it should be reiterated that the present report is only the first in a continuing review of the economic potential of the NWFP and of the measures required to realize this potential. Being the first attempt to systematically explore such subjects, it is inevitable that it would be faced with shortcomings of data and information in a number of areas. The report highlights these areas and makes recommendations for improvement. It also describes the methodology that it used to fill in the lacunae. It is expected that as more detailed and more securely-based data become available, they will be used in subsequent investigations and in revisions to the findings of this report.