

CHAPTER 5: REFORMS WITHIN A SUSTAINABLE FISCAL FRAMEWORK, CONCLUSIONS AND PROSPECTS

5.1 If the NWFP is to rapidly diminish poverty and enhance human development, it must sustain a substantially higher rate of economic growth than in the past and step up investment in human capital. This chapter outlines the fiscal policy framework that will be necessary to realize the high-growth development strategy discussed in previous chapters, and illustrates the strategy with medium-term projections. In addition, it discusses two scenarios (low and intermediate growth). The low growth scenario assumes that the Government of the NWFP will not implement the reform package recommended in this report, and will also be resource-constrained by a continuation of the current NFC award. The intermediate scenario assumes that the provincial government does implement many of the reforms recommended in this report, but is constrained in important ways by the continuation of the current NFC award.

FINANCING A STRATEGY FOR HIGH GROWTH

5.2 **Higher growth will result in faster job creation in the private sector, leading to declining unemployment and poverty levels.** As discussed in earlier chapters, this strategy requires that the provincial government abandon some of the activities it currently performs, focus its efforts on the core functions of government (public goods and services, regulation, and the basic institutions of a market economy — police, judiciary, etc), and perform those functions better. Key outcomes are: real GDP growth rises to 7–7.5 percent over a five-year period, the number of jobs in the private sector rises from 4.7 million in 2005 to 5.9 million in 2010 and unemployment falls to 9.6 percent from 13 percent in 2005 (Tables 5.1 and 5.2). These economic outcomes would lead to a substantial reduction in poverty in the province. Central components of the scenario are covered in the discussion below; additional detail and assumptions are presented in Annex 5.1. Key to raising the rate of economic growth in the province is raising total investment — both public and private — as well as improving efficiency and prioritization of public investments.

5.3 The high-growth scenario requires a substantial increase in total investment, primarily by the private sector, but also by complementary public investment in improving infrastructure and in other activities. Simulation analysis indicates that total investment would need to rise steadily to nearly 20 percent of Provincial GDP (PGDP) by FY 2010, up from an average of 16 percent in FYs 04-05. This increase in investment, combined with the structural reforms discussed in previous chapters, is likely to involve a rise in private sector investment to 15 percent of PGDP, up from 12 percent in FYs 04-05 (see Table 5.2).

5.4 **The high-investment/high-growth strategy proposed in this report will have important development rewards; but it will also require additional public resources (section A).** Stepping up the delivery of roads, irrigation, energy, and other infrastructure requires that both provincial and local governments *increase the level of and returns to public investment* (section C). Moreover, the better delivery of social services and improved efficiency of spending (section B) require that increased public expenditures — combined with sector-specific measures in education, health, and water and sanitation — be complemented by *measures of fiscal decentralization* (section D), so as to give service providers (local governments) additional resources. In short, setting the NWFP on a more rapid growth and poverty reduction path will have significant resource implications for provincial and local government finances and, by implication, at the national level.

the following sources: (i) own provincial and local government resources (i.e., “own resources”); (ii) transfers from the federal government; (iii) payment of Net Hydel Profits by the federal government; (iv) borrowing (both domestic and foreign); and (v) foreign grants.

Table 5.2: Projected Employment, Investment and Fiscal Outcomes

	FY02	FY03	FY04	FY05	FY06	FY07	FY08	FY09	FY10
	Actuals	Actuals	Actuals	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
	Reform Scenario								
Real GDP growth rate (%)	5.4	4.6	5.6	6.3	6.6	6.9	7.2	7.5	7.5
Unemployment rate (%)	13.1	12.9	13.0	12.8	12.4	11.9	11.2	10.4	9.6
	Percent of PGDP								
Gross Investment	14.3	14.2	15.4	16.6	17.9	19.1	19.6	19.5	19.3
Private Investment	11.0	10.3	11.7	12.5	13.7	14.7	15.2	14.9	14.7
Public Investment	3.3	3.9	3.7	4.1	4.2	4.3	4.4	4.5	4.5
o/w Provincial ADP	1.8	1.7	1.9	2.0	2.1	2.1	2.1	2.2	2.2

Source: Bank Staff Estimates.

i. Stepping up own resource mobilization

5.6 A key requisite of the high-growth strategy is a sustained emphasis on revenue reforms and greater efforts at mobilizing the province's own resources, so that the latter rises from 0.7 percent of GDP in 2004 and is maintained at least at 0.8 percent to GDP during 2005–2010; this works out to a 13–15.5 percent nominal annual increase in own revenues.

5.7 **In order to mobilize more of its own resources, the Government of the NWFP will have to improve its tax policy and tax administration.** A number of recently completed policy studies indicate that there is considerable potential to generate higher own revenues over the medium term — by as much as 2.3 times the current level, in real terms.⁶⁸ There is even greater scope for increasing taxes such as Motor Vehicle Tax, Stamp Duty, Professional Tax and Urban Immovable Property Tax to 2.5–3.0 times the FY04 level by FY09. This entails a thorough review of tax structure and exemptions. For instance, although the NWFP government took a bold step of imposing the Agricultural Income Tax (AIT) on all farmers, irrespective of farm size, to-date AIT is levied in only 5 of the 24 districts in the province. This requires an immediate correction, as it not only reduces the base of the tax considerably, but also creates fiscal inequities within the province. Similarly, considerable UIPT revenue is lost due to the government’s reluctance to declare additional rating areas despite considerable urban development and poor assessment of property values. Also, the ongoing conflict between the provincial government and the Cantonment Boards is adversely affecting revenue from the Profession and Calling Tax.⁶⁹ The province also needs to improve tax administration to increase collections within the existing tax statutes, adjust tax rates to remove exemptions and make them more equitable, expand the tax base by bringing in hitherto non-taxed areas under the tax base,⁷⁰ create a better tax climate by opening Tax Facilitation Centers (with support from the private sector) in order to facilitate tax payments, abolishing taxes with little yield, and avoid using regulatory taxes for revenue purposes. The NWFP should also recognize that — despite the view

⁶⁸ These included studies on Reform of Agriculture Income Tax (AIT) and Land Tax in NWFP (2003), Tax Potential in NWFP (2004), and Reform of Tax Administration in NWFP (2004).

⁶⁹ While the Profession and Calling Tax is a provincial tax, the LGO specifies a profession and calling fee which could be levied by the local government. Levying a tax which is more or less similar in character not only creates the perception of double taxation, but can lead to significant collection inefficiencies. It would therefore be more appropriate if the profession fee could be subsumed in the profession tax (to be collected by the provincial E&T department) while the revenue accruing from the fee be transferred to the local governments.

⁷⁰ Beside the Federally Administered Tribal Areas (FATA), which yield no revenue to the provincial government but utilize some of the provincial services, six out of twenty four districts in the provinces (Malakand, Chitral, Lower Dir, Upper Dir, Kohistan and Batagram) are still “non-settled” i.e., are beyond the jurisdiction of tax authorities. This exemption provides major incentives for tax evasion in NWFP.

5.12 **The government should continue to follow a strategic debt management policy to create fiscal space and reduce the debt servicing burden.** It is expected that the public debt stock, which stood at Rs 67 billion at the end of FY02, would reach Rs 97 billion by FY10; most of the new debt build-up would comprise concessional foreign loans. The high-growth scenario estimates that, over the medium term, the public debt-to-PGDP ratio would decline from 17 percent (in FY01-03) to 9 percent by end-FY10. The authorities have already retired Rs 10.1 billion worth of expensive loans during FY03-05 and have created a cumulative fiscal space of Rs 1.9 billion. The government has also formulated a provincial “Debt Management Strategy” with the objective of creating more fiscal space by premature retirement of remaining Cash Development Loans (CDLs) (worth Rs 25 billion by end FY05) and/or renegotiating the terms of the existing loans with the federal government. The GoNWFP should pursue its debt reduction strategy by retiring expensive CDLs (if accepted by the creditor — the federal government) and creating fiscal space whenever it has available cash balances, budget support credits, or better-than-projected federal transfers. With judicious debt management the share of interest payments in total expenditures under the reform scenario would continue to fall sharply from an average of 17.6 percent in FY01-03 to 9 percent by FY06 and to around 6 percent by FY10.

5.13 **The high-growth scenario also assumes continued budget support from international financial institutions (IFIs) with similar amounts as in recent years.** Medium-term projections for this scenario indicate that the NWFP will have adequate available financing to sustain its economic growth and poverty reduction program. With a higher NFC Award, the fiscal deficit is projected to range between 0.4-1.4 percent of PGDP during FYs06-10. Deficits of this magnitude can be adequately financed with concessional foreign credits already in the pipeline. It should be stressed that the reform scenario does assume a continued strong reform effort, which will be a requirement for securing concessional credits.

B. IMPROVING THE COMPOSITION AND EFFICIENCY OF PUBLIC SPENDING

5.14 **Accelerating growth requires not only increasing the overall level of public expenditures, but also improving the composition and efficiency of these expenditures.** This will imply relatively more emphasis on investment and Operations and Maintenance, less on consumption, and better management of investment projects. The government should: (i) increase development spending from an average of 1.8 percent of GDP in FY02-04 to 2.2 percent of GDP by FY09-10. It is expected that a share higher than 6 percent of development funds (the share in recent years, see Table 5.3) would be available to district governments for development purposes; (ii) increase spending on Operations and Maintenance to preserve the value and productivity of public capital stock with a benefit both for past and future investments. Spending on O&M should be raised from 0.9 percent of GDP in 2004 to 1.1 percent of GDP during FYs 05–10. Both provincial and district governments are expected to benefit from easing the constraints on O&M funds; (iii) contain public consumption (excluding O&M and non-salary transfers to districts, which is roughly half of the total transfers to districts) to 4.9 percent of GDP on average over the medium term (first three years), gradually declining to 4.7 percent of GDP by 2010.

5.15 **It is vital that the provincial government not lose the gains from recent fiscal and civil service reforms by expanding the size of public employment or significantly expanding wages and pensions in the province.** A necessary condition for the good development outcomes discussed in this high-growth scenario is that the wage bill will stay around 4.0-4.1 percent of PDGP (45-47 percent of total expenditures), and pension expenditures will be 0.5-0.6 percent of PGDP during FYs05-10. The latter estimate reflects efforts to contain growth in the wage bill (in current prices) of the civil service, but additional pension reforms could be introduced that would limit this liability further. The projections incorporate a general civil service pay increase in FY06 in line with that of the federal government, but rely on growth in the real wage bill to be contained to 3–7 percent per year over the medium term to cover normal increments, permit a small wage increase, and allow small increases in staffing. It also includes an

annual increase in pension expenditures by 10–12 percent in nominal terms and an average of 3-5 percent in real terms.

5.16 The government will have to continue with other reforms to contain less productive current expenditures. It is expected that the government will continue to limit the wheat subsidy to that necessary only to maintain strategic stocks; to keep strict controls on current administrative expenditures; to reduce the remaining contingent liabilities; and to improve management of the deferred liabilities (i.e., the Pension Fund and the General Provident Fund).

5.17 To contribute to economic growth in the province and support private investment, both the level and the composition of provincial public investments has to improve. The government will have to invest between 1.9–2.2 percent of provincial GDP at both the provincial and district levels to engender the higher growth under the reform scenario. These investments will have to create public infrastructure, such as roads, irrigation networks, as well as facilities for education, health, and water supply and sanitation. It is estimated that during the medium term, expenditures on the social sectors will be around 3.7 percent of PGDP (up from 3.4 percent in recent years), and on infrastructure sectors will be about 4 percent of PGDP, up from 3.6-3.7 percent in recent years.

5.18 More public investment will be needed in a number of priority areas. A particular weakness of the province's infrastructure is a shortage of roads, particularly of district roads; however, the total cost of rectifying this deficiency has not yet been fully estimated. In the irrigation sector, constructing small dams in the southern districts has been suggested as the most appropriate strategy; this will cost an additional Rs 400-1,000 million annually over the medium term. In the education sector, more secondary schools (and also primary schools in certain areas) have to be provided. The additional requirements for setting up new primary and secondary schools are estimated at Rs 1000-1200 million annually, which is expected to come partly from provincial resources and partly from additional donor funding. Higher public resources will also be needed to expand water supply and sanitation services in the province under the responsibility of TMAs. Moreover, public funds are required in the agricultural crops and the livestock sectors to enhance productivity and to improve marketing. Public funds will also be needed to provide better social safety nets, such as labor-intensive public works programs, funds for disaster mitigation, and developing special programs for mountainous areas where there are deep pockets of poverty. The fiscal framework broadly incorporates the additional need for resources required to carry out public investments in these priority areas. It is recommended to undertake a more detailed costing of the sector-specific reforms in the coming months to come up with more precise estimates of provincial resources needed for growth and to integrate this exercise with the revision of the rolling Medium-Term Budget Framework (MTBF).

5.19 As noted, this scenario assumes that the set of reforms recommended in this report is implemented. The expanded spending envelope in this scenario is more than sufficient to incorporate the additional spending over and above the baseline associated with implementing the recommended measures. For example, real development spending increases by 10 percent on average every year over the projection period FY06-10. This leaves enough room for the recommended additional investments in education, health, roads, irrigation, agriculture, and water supply and sanitation sectors. This report emphasizes the need to enhance O&M budgets for the various sectors, and stresses that improving the quality of investment spending is perhaps even more important than increasing its quantity.

5.20 There is considerable scope for improving the efficiency of public expenditures. Higher efficiency in current spending will largely come from implementing the reforms covered in Chapter 4 in the discussion on improving service delivery. The NWFP also needs to increase the efficiency of development spending, as public investment projects in the province do not reap the full benefit of the use

of these scarce funds. Better management of public investments is therefore essential and is discussed in the following section.

C. BETTER MANAGING PUBLIC INVESTMENT PROJECTS

5.21 **The profile of provincial public expenditures and the public investment program needs to be better aligned with the goals of growth and poverty reduction set by the province.** Better alignment requires developing a strategic thrust and ensuring the buy-in of various stakeholders. Developing a medium-term budgetary framework (MTBF) could help align expenditure priorities with policy goals. In addition, the Chief Secretary, Finance, P&D and Local Government Departments could help broaden awareness and ownership of the reform program in the provincial line departments and district governments.

Project Planning and Selection

5.22 The efficiency of public investments is reduced because of deficiencies at each stage in the management of public investment expenditures, including project planning and selection, implementation, and monitoring and supervision. Increasing the allocation of funds for O&M in tune with the public investment program is necessary to maintain the province's infrastructure. Past neglect has eroded the existing public infrastructure and experience would suggest that in the future public infrastructure will also be poorly maintained. The recurrent and the development budgets therefore must be better integrated to ensure adequate allocations for O&M. It would also help line departments to strategize, plan, and prioritize the utilization of resources if information on the concept of the MTBF and the tentative sector- and department-wise allocations were widely disseminated.

5.23 **Improve the selection of projects and avoid post-approval escalation of costs.** The project portfolio has been afflicted with selection problems. Unapproved schemes have been made part of the ADP program, which has also been overloaded with projects in which political considerations played an unduly heavy role. To overcome these problems and ensure consistency with the objectives of the provincial reform program, projects should be considered for inclusion in the ADP only after obtaining concept clearance. It is recommended that a representative and adequately empowered Concept Clearance Committee (CCC) should be established to approve and vet projects. This committee should also ensure that only projects with detailed cost estimates are considered. The current practice, where 10 percent buffer is allowed in the cost between project approval and grant of technical sanction, should be reduced to close to half this level in order to ensure more accurate cost estimates from the very beginning of the project cycle.

5.24 In addition, funds are in general poorly prioritized at the planning stage, including the practice of making large block allocations without well-established criteria for project selection.⁷² This results in the available ADP funds being spread thinly over a large number of projects, which in turn delays the completion of projects and produces a high "throw-forward". Formulating clear priorities for the development program requires the use of transparent criteria for selecting projects. Developing and implementing these criteria, and reviewing the existing portfolio of projects in the light of these considerations, must also fall under the remit of a strong Concept Clearance Committee.

⁷² For instance, in 2003/04 most districts did not formulate schemes as given in the ADP, instead block allocations were distributed amongst the Union Councils.

Project Implementation

5.25 **Improve timeliness of funding during the implementation stage.** Projects do not receive funds adequately according to the project's funding schedule. This leads to time and cost over-runs. Planning and budgetary procedures need to ensure provision of funds in accordance with the phasing in the PC-1.

5.26 **The province's new Procurement Law requires more rapid implementation and revision.** The implementation of this law has been slow, and the former procedures and practices continue to be used for the procurement of works, goods, and services. The province must push for the wider implementation of the new Procurement Law and Standard Bidding Documents. Specifically, the government should use open market competition for contracts above a certain level (e.g., Rs 5 million); regularly revise the Composite Schedule of Rates (CSR) on the basis of market prices; open the bidding process to all qualified contractors in line with the evaluation criteria laid out in the bidding documents; abolish post bid negotiations; and reduce the tendency for procurement, unless in emergencies, based on Gallop tenders. Moreover, the government needs to invest in capacity building of the relevant officers to make the best use of the procurement rules. Rules for Consultancy Services should also be made more specific and in consonance with international best practice.

Monitoring and Supervision

5.27 **Improve monitoring and supervision.** Traditionally, the government has shown limited awareness of the importance of project monitoring and has allocated limited resources for monitoring and evaluation (M&E) activities in the Planning and Development department (P&D), the line departments, and district governments. This must change. Higher budgets for staff, equipment, and mobility are needed for more direct monitoring. Testing laboratories are needed in the province for roads and design structures. Staff and institutional capacity for supervision are inadequate. The P&D department and particularly the district governments are poorly equipped to plan, execute, and monitor development projects. There is a critical need to build skills and staff capacity for project design, appraisal and M&E both in the provincial P&D department, in the line departments and in the district governments. This capacity can be built with more local as well as donor resources and the use of local academic institutions with requisite expertise.

5.28 **Improving coordination between local stakeholders and the government can help in M&E.** For instance, public and private sector academic institutions can help in conducting third party validation surveys and other field-based M&E activities. Local private sector consultancy firms can help with M&E of projects related to private sector development. The NWFP Engineering University is well placed to help the provincial government in M&E of physical infrastructure.

D. FURTHERING FISCAL DECENTRALIZATION

5.29 In order to improve delivery of social services, the administrative and functional devolution measures and sector-specific measures discussed in Chapter 4 need to be complemented with corresponding measures in **fiscal decentralization**. This is necessary to give service providers (local governments) additional resources to deliver and expand their authority to make spending decisions and have incentives for making efficiency gains.

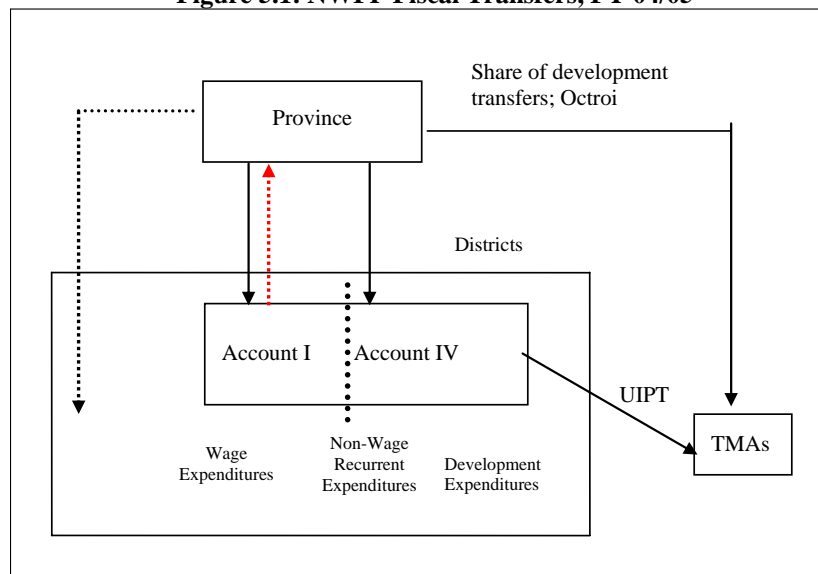
5.30 **To increase resources for local governments, the provincial government could provide district governments with a stronger revenue base and should ensure that the present system does not discourage own revenue mobilization.** The NWFP 2001 Local Government Ordinance (LGO) extended wide-ranging responsibilities over basic service delivery education, health, and infrastructure to

the province's 24 district, 61 TMAs, and respective Union Council executive and political administrations. However, four years after devolution, the prevailing fiscal system provides few opportunities of incentives for local officials (e.g., *nazims* and DCOs) to rationalize local expenditures, or steer more resources to where they are really needed.

5.31 **Improve level of and criteria for transfers to local governments.** Local governments depend on resources from the provincial and federal governments. But the transfer system has design problems, which lead to inequities between districts: while the province is highly dependent on resource transfers from the federal government, there is an even higher dependence of the districts on provincial transfers. Own source revenues at the district and TMA levels are presently negligible to non-existent so that local governments depend almost exclusively on provincial transfers to finance expenditures. Figure 5.1 sketches the directions of the fiscal transfers in NWFP. In addition to continued direct spending by the province at the district level (see leftmost arrow), the provincial government provides a number of transfers to local governments. Given that ADP flows are spent directly by the provincial government and the districts it is important that the spending is coordinated and their recurrent liabilities associated with the capital projects are fully incorporated.

5.32 Provincial-to-local government transfers have been determined under the annual interim Provincial Finance Commission Awards (PFCs) for the past three years, partly due to the absence of a new NFC Award. The principal fiscal transfers to local governments are derived from a share of the provincial divisible pool, which is based on the provincial pool, minus provincial obligatory expenditures. In the NWFP, only fiscal transfers for non-salary and development are allocated on the basis of a formula. All other resources are based on existing establishment costs (e.g., wages and electricity allocations), estimates based on outdated revenue raising estimates (*Zila* and *Octroi* offsets), and estimates of recent revenue collection (e.g., *UIPT* shares). Under the devolution initiative, the NWFP receives 2.5 percent of the federally collected General Sales Tax (GST) collections. These revenues — accounting for a projected 0.8 percent of provincial revenues — are effectively earmarked to local governments, to compensate them for taxes on the inter-regional movement of goods (*Octroi/Zila*) that were abolished in advance of the devolution.

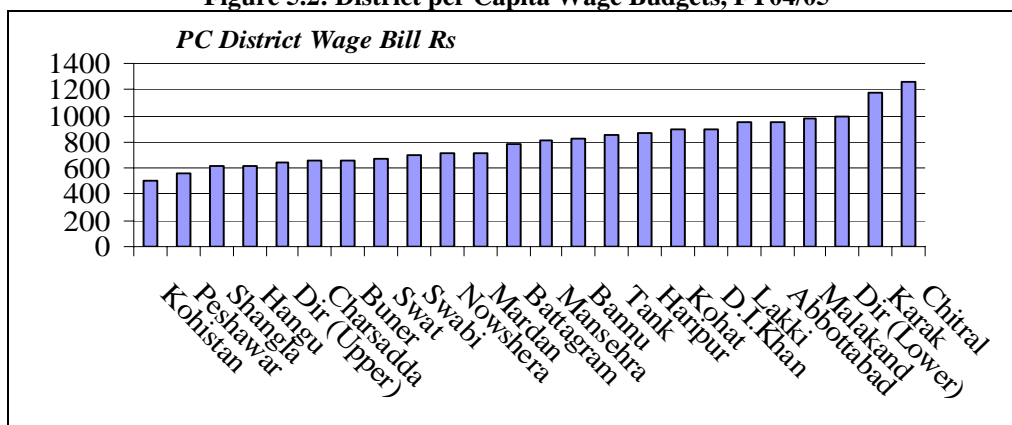
Figure 5.1: NWFP Fiscal Transfers, FY 04/05



5.33 Currently, staffing allocations across districts — and consequently service delivery in such key devolved sectors as basic education — are subject to significant inter-district inequities in per capita wage expenditures (as seen in Figure 5.2). Reforms to the fiscal transfer system will need to address these issues in concert with efforts to address issues of administrative devolution.

5.34 **Give local governments additional revenue autonomy.** Lack of clarity of responsibilities undermines incentives for local revenue collection. In addition, the current system allows for very little revenue autonomy for local governments, and consequently limits the districts’ potential for generating revenues. The larger sources of provincial own revenues are under the jurisdiction of the province. Pilot initiatives to devolve Urban Immovable Property Tax (UIPT) collection in two districts have recently been tried, but without notable success. However, these were poorly implemented without ensuring that local capacity for collection was present. Districts have also been provided with a matching grants incentive for additional revenue collection, but this has not succeeded in the absence of any sanctioned base of district revenues.

Figure 5.2: District per Capita Wage Budgets, FY04/05



5.35 An improved revenue policy will need to provide district governments with an expanded revenue base, and to ensure that the present system does not discourage own revenue mobilization. There is an evident need to allow districts to retain collection of user charges, e.g., user charges in health, user fees for agricultural implements and veterinary services, etc. For some districts, devolution of the AIT may also be an option. The provincial government should also study ways to improve districts’ own revenue potential in other areas, including improvements in the design of providing matching grants for additional revenue collection.

5.36 **Give additional spending autonomy to local governments.** Currently, this authority is limited: 80 percent of the transfers to districts consist of salary bills earmarked for salary payments; the rest are formula-driven allocations for non-salary and district development expenditures. This leaves the districts with limited effective autonomy for local spending, few incentives for making efficiency gains, and no leeway for changing the salary and non-salary mix in expenditures.

The report recommends that the government:

- Give incentives to districts to retain savings in wages, non-salary and development expenditures.
- Allow districts to retain savings if sanctioned posts are abolished.
- Pass on the wage bill of devolved departments through Account 4 as a first step.

5.37 **Improve use of development transfers and related issues:** Development transfers are currently formula-based. However, they are small (less than five percent of total transfers to local governments) and for large parts remain undisbursed. Moreover, the district development funds are fragmented because of the practice of distributing these funds equally between elected members. Typical district development schemes are of Rs 30,000-40,000 (US\$500-670); 80 percent of the district development schemes are under Rs 500,000 (US\$8,300). The current requirement in the 2004/05 PFC Award to use 40 percent of the funds for major schemes is not working. Development funds have so far been underutilized in districts as a result of their limited capacity and other transitional issues. To this effect, the report recommends that the provincial government: provide incentive grants to reduce the backlog of underutilized funds, promote redistribution where utilization is better, and implement targeted capacity-building programs in districts to help improve budget preparation, execution and its overall utilization.

5.38 **Develop an effective strategy to strengthen fiscal decentralization arrangements.** Although the NWFP's budgeted transfer of funds to local governments in FY05 at 32 percent is almost the same percentage of budgeted allocations to local government as in the Punjab, the bulk of the funds in the NWFP is for current expenditures, mainly salaries. The share of local government budgeted development expenditures in the Punjab is 16 percent (in FY05) of the development budget, while the comparable share in the NWFP is only 6 percent (Table 5.3). The NWFP lags behind other provinces, such as the Punjab, in taking advantage of the potential gains from the devolution reforms — a notable example is that the NWFP does not allow districts to retain savings in salary payments from unfilled positions, which is unlike the practice of the Punjab.

Table 5.3: Comparison of District Annual Development Program in the NWFP and the Punjab

	NWFP	Punjab
2003/04 Revised		
Total ADP (Rs million)	12884	39446
District ADP (Rs million)	963.4	6809
District as % of total (%)	7.5	17.3
2004/05 Budget		
Total ADP (Rs million)	16195	434 40
District ADP (Rs million)	963.4	6809
District as % of total (%)	5.9	15.7

Source: NWFP and Punjab Annual Budget Statements 2004/05.

5.39 This report argues that reforms in the recurrent transfer systems (e.g., wages, electricity transfers, O&M offset grants) represent the most immediate priorities. However, all these measures need to be embedded in a medium-term strategy centered on supporting improved outcomes in areas such as education, health, and local infrastructure by providing incentives to local governments. The provincial to local government transfer system could consist of a block grant for the lion's share, topped up with a conditional grant linked to progress in outcomes. Such measures may provide one option to shift away from free-standing vertical programs in the provincial ADP in key areas such as water, sanitation, and district roads, and could prove to be a more effective means of realizing provincial sectoral priorities.

5.40 **Finally, the province will need to improve its monitoring and evaluation system for decentralized policy making, starting with key fiscal and socio-economic indicators at the local level.** A beginning can be made with better generation and use of indicators on key fiscal and socio-economic indicators at the local level. Efforts to strengthen fiscal decentralization are hampered by limited data and information on the district development budgets, district-level monitoring indicators, and indicators for the implementation of development projects in districts. The capacity of districts to collect and analyze data and information is also very limited. It is recommended that capacity be built up for

collecting district-level data; this may require technical assistance to P&D department, and line departments. The PSLM survey of the Federal Bureau of Statistics could provide the baseline data for district level outcome indicators for the social sectors.

5.41 **To summarize, it is clear that the GoNWFP does have the opportunity to set the stage for higher economic growth, employment generation and poverty reduction by undertaking the structural policies discussed in previous chapters of this report and the fiscal measures discussed in this section.** Success in these areas will also require a higher NFC Award. On the other hand, if the provincial government does not step up the pace of reform and/or if it is resource-constrained, living conditions in the NWFP will be slow to improve, and migration will continue to be the only option for many of its citizens.

SCENARIOS: LOW AND INTERMEDIATE

5.42 The **low case scenario** assumes that the provincial government does not accelerate the pace of reform and fails to implement the actions suggested in the previous sections of this report. It also assumes that there will be no new, higher NFC Award for the provinces, and hence the provincial government will be resource-constrained. Compared with the high-growth reform scenario, this will translate into lower private investment (mainly because of the absence of structural reforms); lower public spending on infrastructure, both operation and maintenance and new investment, since less resources will be available and relatively more of them will be spent on public consumption (in particular on civil service salaries); and more limited investment in human capital. Because of slow reform implementation, improvements in the effectiveness of government spending, governance, and implementation capacity will be more limited. As a result, productivity of public capital stock and human capital will be lower. The economy will continue to grow and social indicators to progress, but much more slowly and far behind the outcomes in the high-growth scenario. The annual real GDP growth rate can be expected to stay within the 4–5 percent range, which in per capita terms and in the absence of significant reductions in fertility rates will translate into near stagnation of per capita incomes.

5.43 **An intermediate scenario** would rest on the assumption that the provincial government implements the structural reforms discussed in previous chapters of this report, but that it remains resource-constrained (because the current NFC Award is continued, hydel profits remain limited, or significant external resources are not mobilized). In this scenario, public spending will be constrained. This is of particular concern as the wage bill is likely to increase, following increases at the federal level. The resulting compression of real expenditures — particularly for O&M and development — would imply lower public investment, and this in turn would make it more difficult to attract private investment. A continuation of the current NFC Award⁷³ would imply a revenue shortfall of 0.5-0.6 percent of PGDP, as compared with the high-growth scenario. Economic growth in this “intermediate scenario” could be expected to average between 5.5–5.75 percent over the medium term. This would translate into fewer jobs created and slower poverty reduction than in the high-growth scenario, but of course better than in the low case, no-reform scenario. Net job creation would be about 0.94 million by 2010 (1.2 million in the high growth scenario). The unemployment rate would remain in the 12.5–13 percent range, because of the inability of the slow-growing economy to absorb available workers, compared to falling to 9.5 percent under the reform scenario. Thus, also the intermediate growth scenario results in a significant loss of income and economic opportunities compared with the high-growth scenario.

⁷³ This distributes 37.5 percent of the Divisible Pool to provinces, gives 13.8 percent to the NWFP based on the 1998 share of population, provides subvention grants to the NWFP, and 2.5 percent of GST as Octroi Zila replacement grants and a capped level of NHP at Rs 6 billion.

CONCLUSIONS AND PROSPECTS

5.44 **The NWFP government is at a cross roads.** If it chooses not to be proactive on economic, fiscal and institutional reform, then the outcomes for income growth, job creation, poverty reduction, and human development are likely to stagnate or progress only very slowly, and the government will not meet its announced goals of providing a markedly better life for its citizens. On the other hand, it *is possible* to achieve the higher growth path by undertaking economic and sectoral reforms. The set of reforms recommended in this report is comprehensive and, if implemented, can be expected to bring rapid progress to the province.⁷⁴

5.45 Reforms aiming at improving the investment climate by removing distortions and bottlenecks will raise the productivity of both private and public investment, and will set the stage for the development of a more vibrant and dynamic private sector in both urban and rural areas. Reform must be a continuous process, with a close dialogue between government and the private sector. Key factors to stimulate private sector development are: reducing the role of the state in direct production and concentrating it on providing effective sector regulation; streamlining tax administration and other processes for all enterprises in order to encourage formalization and increase the tax base; strengthening the capacity of the government to execute public-private partnerships; enhancing property rights, clearly defining jurisdiction and enforcement in PATA; improving sector governance; and focusing on selected infrastructure improvements, such as cold storage and logistics. The thrust of these reforms will facilitate the growth of the private sector in general and of SMEs in particular. The latter will be the main source of new jobs.

5.46 Of particular importance for reducing poverty in the province is increasing incomes in rural areas, where the bulk of the poor lives and depends on farming. The recommended reforms in agriculture will raise productivity and incomes in rural areas. Faster growth in industry and services can provide jobs for those released from agriculture.

5.47 The reforms for administrative and fiscal devolution and the sector-specific recommendations proposed in this report for health, education, and water supply and sanitation focus on providing better performance incentives for service providers in the public sector and increased involvement by the private sector. The implementation of these measures should lead to more effective service delivery and improved health and education outcomes.

5.48 It should be reiterated that the program suggested in this report requires substantial increases in public spending on basic infrastructure and needs to be undertaken within a sustainable fiscal framework. Achieving this will require not only the full implementation of the provincial fiscal reforms recommended in this chapter, but also supporting action by the federal government.

⁷⁴ The proposed sequencing of key policy actions recommended in this report is presented in Appendix 1. Successful implementation would in some cases require technical assistance and capacity building with an important role for Pakistan's development partners. An overview of technical assistance requirements is presented in Appendix 2.

ANNEX 5.1: MEDIUM-TERM ECONOMIC FRAMEWORK

This annex provides technical information about the medium-term economic framework in the three scenarios: the reform case, intermediate case, and low case.

Assumptions for Economic Growth and Investments

- Estimates of NWFP's past growth performance (provincial GDP): The historic provincial GDPs of NWFP have been estimated at between 9.5 - 9.9 percent of Pakistan's GDP at current market prices over the period 1990/91 to 2004/05, as estimated by the Bank for this report. The medium-term projections (2005/06 – 2009/10) for NWFP's GDP are based on the Bank's estimated provincial GDP series. The Government of Pakistan's Medium-Term Development Framework (MTDF) macro-economic projections for Pakistan have been used for the national GDP with the new base year of 1999/00.
- GDP deflator: The annual projected changes in the provincial GDP deflator are assumed the same as for the national one.
- Investment: disaggregated Gross Capital Formation (GCF) data are not available by provinces. Since the NWFP is a relatively poor province, largely dependent on agriculture and services sector, its share in the Gross Capital Formation is assumed at 85 percent of NWFP's share in Pakistan's GDP⁷⁵. The MTDF's projected Gross Capital Formation for Pakistan (FYs 05-10) has been used to derive estimated GCF share in NWFP.
- Public investment: historical data on public investment in the NWFP was compiled from the actual utilization of the Provincial Annual Development Program and NWFP's share in the federal government's Public Sector Development Program (PSDP). The data for the 1990s showed that total public investment was around 4.3 percent of the provincial GDP, of which roughly half came from the provincial own ADP and the other half from the PSDP.
- Private investment estimates have been derived residually from estimated total investment minus total public investment.
- Incremental Capital Output Ratios (ICORs): projections in the reform scenario assume ICORs for the NWFP ranging between 2.6-2.9. The ICORs for the intermediate scenario range between 2.7-2.9 and for the low case scenario between 3.0-3.6.
- Real GDP growth: consistent with the above assumptions, real GDP is projected over the medium term (FYs 05-10) in the three scenarios: the reform case, intermediate case, and low case. The growth rates for the NWFP in the reform case are closely related to the projected growth rates in Pakistan's MTDF which range between 6.6-8.0 percent during FYs 05-10. This scenario suggests that NWFP's economic growth would be mirroring the expected GDP growth in Pakistan. The growth rates in the low case are projected to decline every year tapering off by FY10 to close to the long-term average real PGDP growth rate in NWFP (over the last decade or so) of about 4 percent. This scenario assumes that the NWFP would not be able to sustain high real GDP growth rates and would revert to the historical low-growth trend rate after the medium

⁷⁵ In the work on the medium-term projections various other estimates were also tried out to test the robustness of the projections. These other estimates included NWFP's share in GCF at the same level as its share in Pakistan's GDP and also at only 50 percent of the share of Pakistan's GDP.

term. The intermediate scenario is in between the two cases with growth rates ranging between 5.2 and 6.2 percent during FYs 06-10.

Assumptions for the Forthcoming NFC Awards

- For FY05 the preliminary estimates of provincial revenue receipts (based on the discussions with provincial authorities) have been taken for Federal Tax Assignments, provincial revenues and grants, and also for current and development expenditures.
- For FY06, the current NFC Award formula: 37.5 percent to provinces from the Federal Divisible Pool and 13.8 percent population-based share to the NWFP have been used to derive the Federal Tax Assignments. All other non-provincial revenues allocations are also according to the current NFC Award for FY06.
- The current NFC Award formula has been used along with IMF's projections of CBR taxes to derive the Federal Divisible pool for FY07-10 under the intermediate and low case scenarios.
- Under the reform scenario, it is assumed that the next NFC Awards would begin in FY07. IMF's projections of CBR taxes were used to derive the Federal Divisible pool. The share of total divisible pool for provinces has been taken at 47 percent and the share of the NWFP at 15 percent. In this Award, there are no subventions grants to NWFP. Moreover the 2.5 percent General Sales Tax (GST) as Octroi Zilla Tax (OZT) replacement grants have been excluded from the divisible pool transfers. Net Hydel Profits (NHP) have been kept conservatively at the current level of Rs 6 billion.

Assumptions for Provincial Own Revenues and Expenditures

- Annual nominal increase in provincial own tax revenues and non-tax revenues is assumed to range between 13-15.5 percent during FY06-10 based on the expected own-revenue collection outcomes of FY05.
- Wages: the reform scenario assumes normal annual wage increments of 2 -3 percent during FY06-10; a general wage increase of 18 percent in FY06 and of 6.5 - 9 percent annually during FYs 07-10; and 2 percent annual increase in the number of staff during FY06-10. The intermediate and low case scenarios assume a 2-3 percent increase in normal annual increments; 9 - 12 percent increase in general wages (18 percent in FY06) and 2 percent annual increase in staff during FY06-10. The annual increase in the pension bill is assumed to range between 10-13 percent under the reform scenario and by 13-14 percent under the low case scenario.
- The O&M expenditures are assumed to increase by 14-16 percent annually during FY06-10 in the reform scenario, by about 5 percent in the intermediate scenario and by 1-5 percent in the low case scenario.
- The wheat subsidy is assumed to continue to be used only to maintain strategic wheat stocks in the reform scenario. It is assumed to be slightly higher each year in the intermediate and low case scenarios.
- The province's continued focus on social sectors and pro-poor expenditures in the development plan has been assumed in the reform scenario.

Assumptions for Employment and Unemployment

- Employment to growth elasticities have been estimated for the NWFP and for key economic sector using data from the Labor Force Surveys. The estimated average employment/growth elasticity for the NWFP is estimated to be 0.55 and the annual growth rate in labor force during FY05-10 is assumed to be 3.2 percent. The projected unemployment rate is calculated using the base of FY04.

ANNEX 5.2: IMPLICATIONS OF A STRATEGY FOR RATIONALIZING PROVINCE-DISTRICT TRANSFERS IN THE NWFP

- 1. Streamlining how fiscal transfers are made to local governments can help address some of the rigidities that are undermining equitable and effective decentralized service delivery in NWFP.** Only fiscal transfers for development are presently allocated on a formula basis in NWFP. These account for less than five percent of total overall local government budgets. All other resources are based on existing establishment costs (e.g., wages and electricity allocations), estimates based on outdated revenue raising estimates (Zila and Octroi offsets), and estimates of recent revenue collection (e.g., UIPT shares).
- 2. Moving to a larger formula based allocation of fiscal transfers will enhance transparency of the existing system and over time help promote the effective use of public resources at the local level.** Increased transparency in the overall transfer system beyond the fraction allocated for development will focus attention on some of the major the inequities of the current systems.⁷⁶ Allocating monies based on existing local establishment sizes and anachronistic measures of revenue mobilization (i.e., Zila and Octroi) makes for a poor match with existing expenditure needs. This system provides few opportunities of incentives for local officials (e.g., *nazims* and DCOs) to rationalize local expenditures, while steering more resources to where they are really needed. Moreover, the extremely limited base for own local revenues conspires with the current transfer system to marginalize own resource mobilization at the local level.
- 3. The district allocation simulations presented in this annex are meant to alert policy makers in the NWFP to the issues that must be addressed now to make progress over time to achieve a better fiscal transfer system.** One starting point is that reaping the benefits of a more rational transfer allocation will require thinking now about what type of formula design to choose, and how these compare to current allocations. Critically our simulations underscore that any commitment to rationalize the fiscal transfer system will entail a transition strategy. If one compares current fiscal allocations to individual districts with what they should be receiving on a formula basis, it is clear that making these changes from one budget year to the next would be too drastic and unrealistic, potentially disrupting service delivery and providing political unviable. However, if changes are not made in the context of a medium-term plan (e.g., 3-5 year horizon), the risk is that outmoded and ineffective allocation will linger over time, undermining public service delivery in the NWFP.

⁷⁶ This annex seeks to further illuminate the previous discussions in the second World Bank Structural Adjustment Credit to the NWFP that suggested that NWFP should move incrementally towards a formula based allocation of the district salary bill. Within five years, the formula should allow for “employment levels based on similar per capita ratios, with some allowance for the diseconomies faced by small districts and remote rural districts.”

Figure A-1: Current Per Capita Wage Expenditures by District

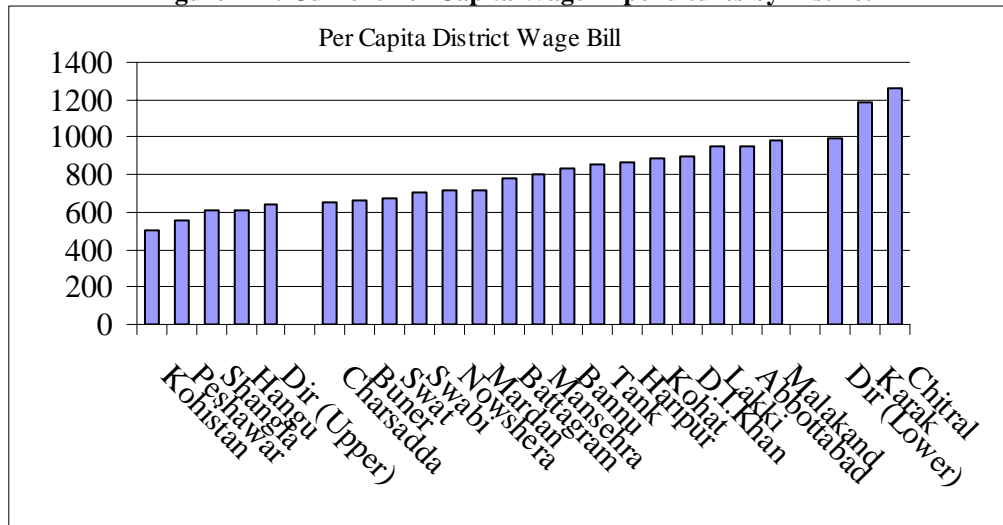
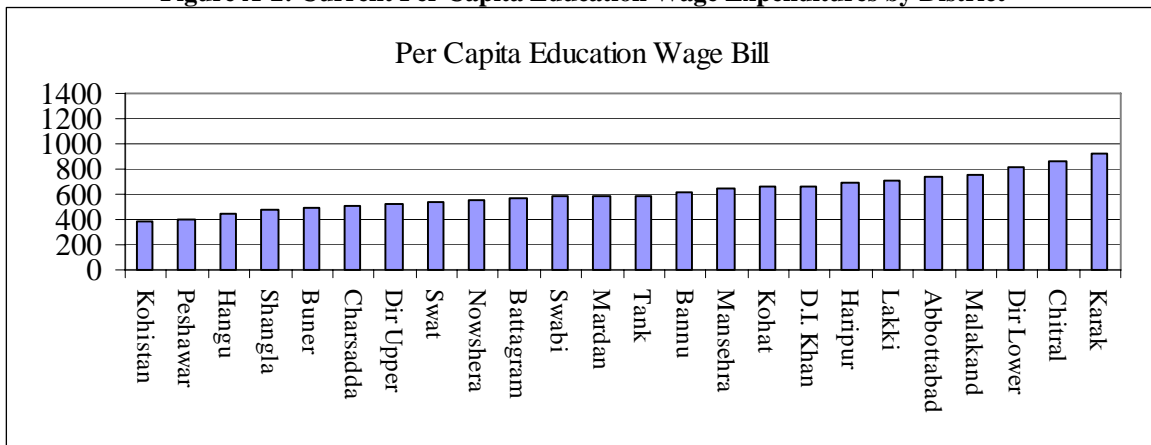


Figure A-2: Current Per Capita Education Wage Expenditures by District

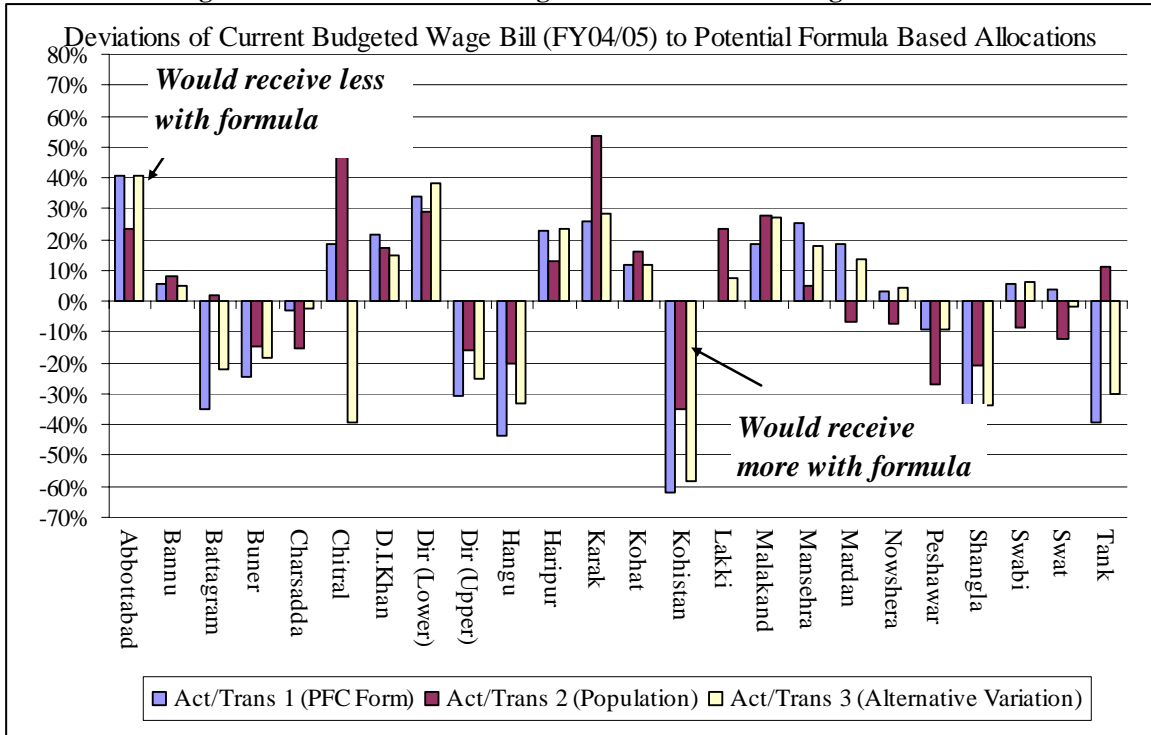


4. **Comparing illustrative formula allocations with existing allocations underscores the NWFP’s reform challenge in this area.** Figure A-1 shows the current per capita wage allocation of individual districts. Kohistan and Shangla, two remote districts, rank among the lowest in per capita budgeted wage allocations. The large urban district of Peshawar also ranks among the lowest. We attempted to get actual realizations of wage expenditures. Regrettably, despite repeated requests to the NWFP Accountant General’s Office (AGO), these were not forthcoming. However, field visits suggested that in districts such as Shangla a significant portion of positions were unfilled, and hence that budget realizations were actually lower. Under current arrangements, districts are not able to allocate these “savings” to other purposes.

5. Figure A-2 presents per capita wages for education only. The graph highlights the importance of the education sector in district recurrent expenditures. These typically account for well over half of district wage expenditures. For comparison, we calculated how much each district would receive of the overall wage budget (estimated Rs 14.4 billion) based on the three formulas below. The specific choice of formulas would need to be subject to further analysis and discussion, and hence the actual formula should be seen as illustrative only.

- A. PFC Award Formula (50 percent Population, 25 percent Backwardness, 25 percent Infrastructure)
- B. Population only
- C. 75 percent Population, 10 percent Backwardness, 10 percent Inverse Population Density, 5 percent Equal Lump Sum

Figure A-3: Actual District Budgeted versus Formula Wage Allocations



6. The current wage allocations of Abbottabad are higher than they would be under any of the three formula allocations. Under a pure formula allocation, the district would over time receive less under a formula. In contrast, Kohistan and Shangla are two districts that currently have allocations far lower than a hypothetical formula allocation. The reality of this situation may be worse if realizations are actually far lower than budgets in these remote districts. The choice of formula however matters. The first two formulas would suggest that Chitral is receiving too many wage allocations. However, it is under-resourced by these standards under the third formula, which gives increased weight to remoteness and area.

7. **The most appropriate choice of formula will need to be catered to the specific context of the NWFP.** For example, a district such as Peshawar may benefit from economies of scale in service provision. Alternatively, the NWFP’s policy makers will need to discuss whether there are really special needs in districts such as Abbottabad or Karak that merit the relatively high wage budgets compared to these illustrative formula standards.

8. **Finding consensus concerning district allocation formula is a prerequisite to a medium-term implementation strategy.** Given a managed adjustment strategy, how fast and/or for how long would relative wage bills in different districts need to be adjusted to ensure a more equitable distribution? In other words, how would increases in Kohistan need to be managed against steady or decreasing allocations for Abbottabad?

9. Table A-1 provides some indicative estimates. Assuming an annual real increase or decrease of 3 or 5 percent per year, we estimated how many years it would take to reach the formula baseline allocation.⁷⁷ If we were to choose a formula based on population only formula (B), we would need seven years for Abbottabad to reach the formula level with an annual decline of 3 percent and four years with five percent. Kohistan would take 14 and 9 years of increases respectively to reach benchmark levels.

10. An alternative perspective calculates the annual rates of change in the district wage bill necessary to reach the formula benchmark in five or ten years.⁷⁸ While most district scenarios require adjustments of less than ten percent per year, other like Kohistan deviate so much from formula benchmarks that they would require more dramatic adjustment trajectories in the medium term. While the simulations underscore the extent of this challenge for certain districts, they also appear to suggest significant degree of resource misallocation, or certainly inequities, presently confronting districts.

11. **More equitable wage allocations across districts can be managed in a number of ways, and need not entail mechanistic cuts or additions to transfers in individual districts.** The simulations assume no nominal growth in the overall wage pool. Given a certain growth in the overall allocation to wages, certain currently over-endowed districts may simply have to be subject to zero nominal growth in their wage allocations, rather than actual decreases. At the same time, those districts falling well below the benchmark formula allocation would receive the bulk of any nominal increases. An alternative strategy might be to simply bring the real outliers in a more tolerable band from the benchmarks (e.g., +/- 10 percent). The key in any such exercise would be to make an appropriate allocation more systematic and transparent through the adoption of a formula. Given the importance of the education sector, a sub-component formula could be tailored to that sector. Any such allocation would need to cater to covering existing costs for enrolled students, as well as extending education to those groups currently not enrolled. **While conditional grants can play an important role in intergovernmental fiscal systems, the key for the NWFP will be to fix basic allocations while progressively granting them autonomy over a tangible part of those resources.** Our simulations suggest that there are currently significant imbalances in recurrent expenditures. These imbalances have emerged and persisted in the context of a highly centralized system. One of the potential benefits of decentralization is that it will make these types of differences more transparent.

12. Conditional grants are seen as a way of ensuring that the priorities of a higher level of government are reflected in local expenditures. For example, matching grants will further leverage local expenditures through more limited specific transfers. However, these require a basic degree of local autonomy to be effective, and may themselves be hard to monitor. Before increasing the complexity of the current system, the priority in the NWFP should be to rationalize the current basic allocations over the medium-term.

⁷⁷ $T^{**} = \ln(L_1/L_0) / \text{Annual Change}^*$ where L_1 and L_0 are relative levels at the end and beginning period, and T is the number of years. For our simulations, L_0 is the ratio of the actual to formula allocation, whereas L_1 is 100. If $L_1 > L_0$, the adjustment rate will be negative.

⁷⁸ $\text{Annual Change}^{**} = \ln(L_1/L_0)/T^*$, where T is the number of years assumed.

Table A-1: NWFP: Potential Transition Paths of Current District Wage Bills to Formula Based Allocation

Baseline (% Formula Allocation)	A. PFC Formula			B. Population Formula				C. Alternative Variation								
	A. PFC Formula	B. Population Formula	C. Further Variation	I. Years with Fixed Annual Change		II. Annual Percent Change with Limited Number of Years		I. Years with Fixed Annual Change		II. Annual Percent Change with Limited Number of Years		I. Years with Fixed Annual Change		II. Annual Percent Change with Limited Number of Years		
District	Percent			(+/- 3%)	(+/- 5%)	(5 Years)	(10 Years)	(+/- 3%)	(+/- 5%)	(5 Years)	(10 Years)	(+/- 3%)	(+/- 5%)	(5 Years)	(10 Years)	
Abbottabad	100	41	23	41	(11)	(7)	-7	-3	(7)	(4)	-4	-2	(11)	(7)	-7	-3
Bannu	100	6	8	5	(2)	(1)	-1	-1	(3)	(2)	-2	-1	(2)	(1)	-1	-1
Battagram	100	-35	2	-22	14	9	9	4	(1)	(0)	0	0	8	5	5	2
Buner	100	-25	-14	-18	9	6	6	3	5	3	3	2	7	4	4	2
Charsadda	100	-3	-15	-2	1	1	1	0	6	3	3	2	1	0	0	0
Chitral	100	19	64	-39	(6)	(3)	-3	-2	(16)	(10)	-10	-5	17	10	10	5
D.I.Khan	100	21	17	15	(6)	(4)	-4	-2	(5)	(3)	-3	-2	(5)	(3)	-3	-1
Dir (Lower)	100	34	29	38	(10)	(6)	-6	-3	(8)	(5)	-5	-3	(11)	(6)	-6	-3
Dir (Upper)	100	-31	-16	-25	12	7	7	4	6	4	4	2	10	6	6	3
Hangu	100	-43	-20	-33	19	11	11	6	8	5	5	2	14	8	8	4
Haripur	100	23	13	24	(7)	(4)	-4	-2	(4)	(2)	-2	-1	(7)	(4)	-4	-2
Karak	100	26	54	28	(8)	(5)	-5	-2	(14)	(9)	-9	-4	(8)	(5)	-5	-2
Kohat	100	12	16	12	(4)	(2)	-2	-1	(5)	(3)	-3	-1	(4)	(2)	-2	-1
Kohistan	100	-62	-35	-59	32	19	19	10	14	9	9	4	29	18	18	9
Lakki	100	0	23	8	(0)	(0)	0	0	(7)	(4)	-4	-2	(2)	(1)	-1	-1
Malakand	100	19	28	27	(6)	(3)	-3	-2	(8)	(5)	-5	-2	(8)	(5)	-5	-2
Mansehra	100	25	5	18	(7)	(4)	-4	-2	(2)	(1)	-1	0	(6)	(3)	-3	-2
Mardan	100	18	-7	13	(6)	(3)	-3	-2	2	1	1	1	(4)	(3)	-3	-1
Nowshera	100	3	-7	5	(1)	(1)	-1	0	3	2	2	1	(1)	(1)	-1	0
Peshawar	100	-9	-27	-9	3	2	2	1	11	6	6	3	3	2	2	1
Shangla	100	-46	-21	-34	20	12	12	6	8	5	5	2	14	8	8	4
Swabi	100	6	-8	6	(2)	(1)	-1	-1	3	2	2	1	(2)	(1)	-1	-1
Swat	100	4	-12	-2	(1)	(1)	-1	0	4	3	3	1	1	0	0	0
Tank	100	-40	11	-30	17	10	10	5	(4)	(2)	-2	-1	12	7	7	4
Rate (%) / Years					3.0	5.0	5	10	3.0	5.0	5	10	3.0	5.0	5	10
Highest Reduction					(11)	(7)	-7	-3	(16)	(10)	-10	-5	(11)	(7)	-7	-3
Highest Increase					32	19	19	10	14	9	9	4	29	18	18	9