

**IMPACT OF ECONOMIC AND INSTITUTIONAL
FACTORS ON THE SOCIO-ECONOMIC
GROWTH OF KHYBER PAKHTUNKHWA,
PAKISTAN**

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IMPACT OF ECONOMIC AND INSTITUTIONAL FACTORS ON
THE SOCIO-ECONOMIC GROWTH OF KHYBER
PAKHTUNKHWA, PAKISTAN

MUHAMMAD IMRANULLAH

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ABSTRACT

The study explores the impact of perceived political, cultural, religious and economic factors on the perceived economic growth of Khyber Pakhtunkhwa in users of formal and informal financial systems. The study applied survey questionnaire technique to record responses from respondents associated with firms from formal and informal financial institutions to gain insight into perceived political, cultural, religious and economic factors. Sample of 500 respondents is taken for the survey, 369 responded, while 309 were found valid.

Diversified themes associated with the study were identified and discussed. The results of the study and its implications brought to light the role of formal and informal financial institutions in the context of strategic orientation. Findings of the study are examined in relation to analysis for users of formal financial system which exhibited a change in perceived economic growth to be accounted to perceived political stability, perceived cultural stability, perceived economic environment and perceived religious affiliation in the users of formal financial system. However, the results of informal financial system revealed a significant impact of perceived cultural stability, perceived economic environment, and perceived political stability. Perceived religious affiliation had an insignificant impact on perceived economic growth.

The study concludes that once a strong coherence between political, cultural, religious and economic environment is buildup, the economy of KP will starts flourishing. The study recommends that the Government should take steps to channelize the informal setups in to the main stream of the economy by bringing industrial and taxation reforms so that the fruits from the formal financial system can be capitalized.

APPROVAL PAGE

I certify that I have supervised /read this study and that in my opinion it conforms to acceptable standards of scholarly presentation and is fully adequate, in quality and scope, as a thesis for the fulfilment of the requirements for the degree of Doctor of Philosophy.

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DECLARATION

I hereby declare that the thesis is submitted in fulfillment of the PhD degree is my own work and that all contributions from any other persons or sources are properly and duly cited. I further declare that the material has not been submitted either in whole or in part, for a degree at this or any other University. In making this declaration, I understand and acknowledge any breaches in this declaration constitute academic misconduct, which may result in my expulsion from the programme and/or exclusion from the award of the degree.

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Dated: 1st June, 2018

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TABLE OF CONTENTS

ABSTRACT	ii
APPROVAL	iii
DECLARATION	iv
ACKNOWLEDGEMENTS	vi
LIST OF TABLES	xi
LIST OF FIGURES	xiii
ABBREVIATIONS AND ACRONYMS	xiv
CHAPTER 1 INTRODUCTION	1
1.1 Background of the study	1
1.1.1 The Concept of Economic Growth	11
1.1.2 Determinants of Economic Growth	18
1.1.3 The construct of formal and informal financial system	20
1.1.4 Status of economy of Khyber Pakhtunkhwa province	22
1.2 Problem statement	27
1.3 Objectives of the study	32
1.4 Research Questions	34
1.5 Scope of the study	34
1.6 Significance of the study	35
CHAPTER 2 LITERATURE REVIEW	38
2.1 Theoretical Framework	38
2.1.1 Theory of Economic Growth -Classical Growth Theory	38
2.1.2 Harrod-Domar Growth Model	39
2.1.3 Neoclassical Growth Theory	39
2.1.4 New Growth Theory	40
2.1.5 Financial Development Theory	41
2.1.6 Mckinnon-Shaw Finance Theory	43
2.1.7 Post Keynesianism-Structuralism	44
2.2 Theories on Informal Economy	48
2.2.1 The Legal Theories of Financial Development	51
2.2.2 Theories of Economic Development	57
2.2.3 Financial Reform and Economic Development	61
2.3 Financial Systems	63
2.4 Culture and Perceived Economic Growth	64
2.5 Political Factors and Perceived Economic Growth	75
2.6 Formal and Informal Financial Systems	79

2.7	Informal and Formal Financial Markets in Pakistan	83
2.8	Religion and Perceived Economic Growth	98
2.8.1	Salvation and Economic Incentives in the World Religions	105
2.8.2	Why Religion?	106
2.9	Financial Inclusion	116
2.9.1	Poverty and Financial Inclusion	118
2.9.2	Measuring Financial Inclusion	122
2.9.3	Financial Inclusion Theories on Financial Growth	126
2.9.4	Financial Inclusion and Enterprise	136
2.9.5	Financial Inclusion and Broad Economic Spectrum	137
2.9.6	Links between the Informal and Formal Sectors	138
2.10	Current Status	161
2.11	Gap in the Literature	161
2.12	Hypotheses of the Study	166
2.13	Conceptual Framework	167
	CHAPTER 3 RESEARCH METHODOLOGY	168
3.1	Research Philosophy	168
3.2	Research Design	170
3.3	Population of the Study:	171
3.4	Sample of the Study	172
3.5	Sampling Technique	172
3.6	Instrument Design	173
3.6.1	Reliability and Validity of Data	173
3.7	Instrument Items	175
3.7.1	Perceived Political Stability	175
3.7.2	Perceived Cultural Stability	176
3.7.3	Perceived Religious Affiliation	177
3.7.4	Perceived Economic Environment	177
3.7.5	Perceived Economic Growth	178
3.7.6	Pre-testing	182
3.7.7	Content validity – Stage 1	182
3.7.8	Readability-Stage Two	184
3.7.9	Pilot Study – Stage 3	184
3.7.10	Mistake Elimination-Stage Four	185
3.8	Handling Missing Data	186
3.9	Data Analysis	186
3.9.1	Profile Analysis	187

3.10	Time Horizon of the Research	188
3.11	Unit of Analysis	188
3.12	Study Setting	189
3.13	Ethical Considerations	189
3.14	Data Analysis Techniques	191
3.14.1	Descriptive Statistics	191
3.14.2	Factor Analysis	191
3.14.3	Validity	192
3.14.4	Construct Validity	193
3.14.5	Reliability Assessment	194
3.14.6	Structural Equation Modeling	194
CHAPTER 4 DATA ANALYSIS & RESULTS		201
4.1	Introduction	201
4.2	Survey responses	202
4.2.1	Data screening and preliminary analysis	203
4.2.2	Missing data and outliers	203
4.2.3	Evaluation of Normality	203
4.2.4	Common Method Bias	203
4.3	Respondent Profile	205
4.3.1	Age of the Respondents	206
4.3.2	Education of the Respondents	207
4.3.3	Gender of the Respondents	208
4.3.4	Occupation of the Respondents	209
4.3.5	Financial System Primarily Used	210
4.3.6	Magnitude of Financial System Usage	211
4.3.7	Switching Intention of Financial System by the Respondents	212
4.3.8	Tax Benefits Associated with Usage of Financial System	213
4.4	Qualitative Analysis	214
4.4.1	Major Obstacles in using Formal Financial System	215
4.4.2	Factors Facilitating use of Formal Financial System	224
4.4.3	Major obstacles in using Informal Financial System	231
4.4.4	Factors Facilitating use of Informal Financial System	238
4.5	Descriptive Statistics	240
4.5.1	Perceived Political Stability	240
4.5.2	Perceived Cultural Stability	241
4.5.3	Perceived Religious Affiliation	242
4.5.4	Perceived Economic Environment	243

4.5.5	Perceived Economic Growth	244
4.5.6	Frequency Comparison for Perceived Political Stability	245
4.5.7	Frequency Comparison for Perceived Cultural Stability	250
4.5.8	Frequency Comparison for Perceived Religious Affiliation	252
4.5.9	Frequency Comparison for Perceived Economic Environment	255
4.5.10	Frequency Comparison for Perceived Economic Growth	258
4.5.11	Mean Comparison for Perceived Political Stability	262
4.5.12	Mean Comparison for Perceived Cultural Stability	263
4.5.13	Mean Comparison for Perceived Religious Affiliation	265
4.5.14	Mean Comparison for Perceived Economic Environment	266
4.5.15	Mean Comparison for Perceived Economic Growth	268
4.6	Structural Equation Modeling and Partial Least Squares	269
4.6.1	SEM: Covariance-based SEM VS. Component-based SEM	269
4.6.2	Partial Least Squares (PLS)	271
4.6.3	PLS Evaluation	272
4.6.4	Evaluating the Measurement Model	273
4.6.5	Evaluating Structural Model	275
4.7	Reliability Analysis	281
4.7.1	Construct Validity	282
4.8	Structural Equation Model	285
4.9	Regression Results	287
4.10	Comparison between Users of FFS and IFS	293
4.10.1	Users of Formal Financial System	293
4.10.2	Users of Informal Financial System	296
4.11	Difference between Users of FFS & IFS	299
CHAPTER 5 DISCUSSION AND CONCLUSION		301
5.1	Introduction	301
5.2	Research Objectives and Research Questions of the Study	301
5.3	Conclusive Discussion of Results	303
5.4	Assumptions and Limitations	307
5.5	Policy Recommendations	309
5.6	Recommendations for Further Research	310
	REFERENCES	311
	APPENDICES	357

LIST OF TABLES

<i>Table 1: Ethnic group composition in Pakistan</i>	1
<i>Table 2: Province Wise GDP Contribution</i>	12
<i>Table 3: Provincial GDP (PPP)</i>	13
<i>Table 4: Provinces share in Pakistan total GDP</i>	13
<i>Table 5: Detail Population Khyber Pakhtunkhwa Census 2017</i>	23
<i>Table 6 Usage of financial products from the formal financial institutions</i>	86
<i>Table 7 Features of Formal and Informal Financial System</i>	90
<i>Table 8: Access Strand in Pakistan</i>	134
<i>Table 9: KP Industrial Estates</i>	137
<i>Table 10: Characteristics of Positivism</i>	169
<i>Table 11: Scale Items for Perceived Political Stability</i>	176
<i>Table 12: Scale Items for Perceived Cultural Stability</i>	177
<i>Table 13: Scale Items for Perceived Religious Affiliation</i>	177
<i>Table 14: Scale Items for Perceived Economic Environment</i>	178
<i>Table 15: Scale Items for Perceived Economic Growth</i>	179
<i>Table 16: Summary Sources of Instrument Items</i>	179
<i>Table 17: Total Variance Explained</i>	204
<i>Table 18: age</i>	206
<i>Table 19: Table Education of the Respondents</i>	208
<i>Table 20: Table Gender of the Respondents</i>	208
<i>Table 21: Table Occupation Type</i>	210
<i>Table 22: Category of Financial System Used</i>	211
<i>Table 23: Magnitude of Financial System Usage</i>	212
<i>Table 24: Plan to switch to alternative Financial System</i>	213
<i>Table 25: Tax Incentive Associated with Financial System</i>	214
<i>Table 26: Descriptive Statistics for Perceived Political Stability</i>	241
<i>Table 27: Descriptive Statistics for Perceived Cultural Stability</i>	242
<i>Table 28: Descriptive Statistics Perceived Religious Affiliation</i>	243
<i>Table 29: Descriptive Statistics for Perceived Economic Environment</i>	244
<i>Table 30: Descriptive Statistics for Perceived Economic Growth</i>	245
<i>Table 31: Frequency Comparison for Perceived Political Stability</i>	247
<i>Table 32: Frequency Comparison for Perceived Cultural Stability</i>	251

<i>Table 33: Frequency Comparison for Perceived Religious Affiliation</i>	253
<i>Table 34: Frequency Comparison for Perceived Economic Environment</i>	256
<i>Table 35: Frequency Comparison for Perceived Economic Growth</i>	260
<i>Table 36: Mean Comparison for Perceived Political Stability</i>	263
<i>Table 37: Mean Comparison for Perceived Cultural Stability</i>	264
<i>Table 38: Mean Comparison for Perceived Religious Affiliation</i>	266
<i>Table 39: Mean Comparison for Perceived Economic Environment</i>	267
<i>Table 40: Mean Comparison for Perceived Economic Growth</i>	269
<i>Table 41: Initial Loadings, Alpha, CR, and AVE</i>	277
<i>Table 42: Factor Loading of the Constructs in the modified model</i>	280
<i>Table 43: Reliability analysis of the constructs</i>	282
<i>Table 44: AVE for constructs</i>	282
<i>Table 45: Fornell and Larcker Criterion</i>	283
<i>Table 46: Cross Loadings</i>	284
<i>Table 47: Heterotrait-Monotrait Ratio (HTMT)</i>	285
<i>Table 48: Effect Size for Independent Variables</i>	287
<i>Table 49: Hypotheses Testing</i>	288
<i>Table 50: Effect Size for Independent Variables for Users of FFS</i>	294
<i>Table 51: Hypotheses Testing for Users of FFS</i>	295
<i>Table 52: Effect Size for Independent Variables for Users of IFS</i>	297
<i>Table 53: Hypotheses Testing for Users of Informal Financial System</i>	297
<i>Table 54: Model Significance comparison between Users of FFS and IFS</i>	299
<i>Table 55: Group Statistics</i>	300
<i>Table 56: Independent Samples Test</i>	300

LIST OF FIGURES

<i>Figure 1: Pakistan Capital Investment, percent of GDP</i>	15
<i>Figure 2: GDP growth rate of Pakistan</i>	28
<i>Figure 3: Political factor and Economic growth in Pakistan</i>	29
<i>Figure 4: Scope of Financial Inclusion (Source: Sahrawat, 2010)</i>	118
<i>Figure 5: Four measures of financial inclusion</i>	122
<i>Figure 6: Measurement Objectives</i>	125
<i>Figure 7: Conceptual Framework</i>	167
<i>Figure 8: Research Design</i>	171
<i>Figure 9: Age of the Respondents</i>	207
<i>Figure 10: Gender of the Respondents</i>	209
<i>Figure 11: Occupation Type</i>	210
<i>Figure 12: Magnitude of Usage</i>	212
<i>Figure 13: Plan to switch to FS</i>	213
<i>Figure 14: Tax Incentive Associated with Usage of Financial System</i>	214
<i>Figure 15: An example representing PLS path model</i>	272
<i>Figure 16: Structural Model</i>	276
<i>Figure 17: Initial Model with Item Loading</i>	278
<i>Figure 18: Final Model with Item Loading</i>	279
<i>Figure 19: Overall Structural Model with R2</i>	286
<i>Figure 20: Structural Model for hypotheses testing with T-Model</i>	288
<i>Figure 21: Structural Model Explaining Variance in User of FFS</i>	293
<i>Figure 22: Structural Model with T values: Users of FFS</i>	295
<i>Figure 23: Structural Model with Explained Variance: Users of IFS</i>	296
<i>Figure 24: Structural Model with T-value: Users of IFS</i>	298

ABBREVIATIONS AND ACRONYMS

ANOVA	Analysis of Variance
ATM	Automated Teller Machine
AVE	Average Variance Extracted
AWKUM	Abdul Wali Khan University Mardan
BISP	Benazir Income Support Program
BOIT	Board of Investment & Trade
CFA	Confirmatory Factor Analysis
CPEC	China Pakistan Economic Corridor
CR	Critical Ratio
CSA	Cooperative Saving Association
EFA	Exploratory Factor Analysis
FI	Financial Inclusion
FIIP	Financial Inclusion & Infrastructure Policy
FFI	Formal Financial Institutions
FFS	Formal Financial System
GDP	Gross Domestic Product
GNP	Gross National Product
HTMT	Heterotrait-Monotrait Ratio
HEC	Higher Education Commission
IDS	Institute of Development Studies
IFI	Informal Financial Institutions
IFS	Informal Financial System
ILO	International Labor Organization

IQ	Intelligence Quotient
KP	Khyber Pakhtunkhwa
KPCCI	Khyber Pakhtunkhwa Chamber of Commerce & Industry
LV	Latent Variable
LOT	Legal Origins Theory
MFB	Micro Finance Bank
MFI	Micro Finance Institution/Insurance
MV	Manifest Variable
NFIS	National Financial Inclusion Strategy
PCS	Perceived Cultural Stability
PEE	Perceived Economic Environment
PEG	Perceived Economic Growth
PIDE	Pakistan Institute of Development Economics
PLS	Partial Least Square
PPS	Perceived Political Stability
PRA	Perceived Religious Affiliations
PKR	Pakistani Rupee
RSP	Rural Support Program
RQ	Research Question
SBP	State Bank of Pakistan
SCA	Savings & Credit Association
SECP	Securities & Exchange Commission of Pakistan
SEM	Structural Equal Model
SMB	Small & Medium Businesses
SME	Small & Medium Enterprise

SPSS	Statistical Package for Social Scientists
USD	United States Dollar
WBER	World Bank Economic Review

CHAPTER 1 INTRODUCTION

1.1 Background of the study

Pakistan came into being and got independence on 14th August, 1947 from British domination. Pakistan's official religion is Islam where 95% of its 210 million population are Muslim and 5% constitute population belonging to other religions. Being situated on a strategic belt surrounded by Iran, Afghanistan, India, and China, invaders used this land to conquer foreign lands. The land is historically ruled by Mauryan, Achaemenid, Mongol, Mughal and Delhi Sultanate. Though Urdu is the national language of Pakistan but over 60 more languages are being spoken in different parts of Pakistan. Local population have kept alive their ethnic identity in terms of unique cultural values and languages.

The following table exhibits the ethnic classification of Pakistani population.

Table 1: Ethnic group composition in Pakistan

Rank	Ethnic Group	Share of Total Population
1	Punjabi	44.7%
2	Pashtuns	15.4%
3	Sindhi	14.1%
4	Sariaki	8.4%
5	Muhajir	7.6%
6	Baloch	3.6%
7	Other Groups	6.2%

Source: National Population Census (2017)

Countries in the South Asian hemisphere in particular are under the tremendous influence of economic slump but the situation in war torn areas in Pakistan like the province of Khyber Pakhtunkhwa (KP) is even worse. Khyber Pakhtunkhwa is one of the four administrative provinces of Pakistan, located in the northwestern region of

the country along the international border with Afghanistan and which is lagging behind economically then other provinces of Pakistan. Khyber Pakhtunkhwa is the third-largest province of Pakistan by the size of both population and economy, though it is geographically the smallest of five provinces in Pakistan. Khyber Pakhtunkhwa shares a border with Punjab, Baluchistan, Azad Kashmir, Gilgit-Baltistan, and the capital Islamabad. The Khyber Pakhtunkhwa province in Pakistan is one of those areas which are badly affected by the war-like situation and wave of terrorism in the region. The post 9/11 incidents and the hot pursuit of terrorists in Afghanistan by the North Atlantic Treaty Organization (NATO) forces led by the United States of America has put the Khyber Pakhtunkhwa province in front in the war against terrorism. According to the Economic Survey of Pakistan, the Khyber Pakhtunkhwa province is contributing 13 % to the Gross Domestic Product (GDP) of the country as against a total population of 27 million which amounts to 14.69 % of the total population of Pakistan. According to official reports, the current annual economic growth in Khyber Pakhtunkhwa province has been recorded at 4.5 %. Remittances from overseas Pakistanis amount to 5 % of total GDP and it is interesting to note that every fourth overseas Pakistani belongs to Khyber Pakhtunkhwa province. The major industries include construction, manufacturing, livestock, mining and tourism.

The poverty rate amounted to 39 % which makes it second poorest province in Pakistan, Baluchistan being the first. The contribution made to the GDP by services sector is 67 % while industry contributes 20 % and agriculture contributes just 13 % (Sources: Reclaiming Prosperity in Khyber Pakhtunkhwa: Economic Growth Strategy: Medium Term Inclusive Growth Strategy. P & D, Government of Khyber Pakhtunkhwa, 2014). As the Khyber Pakhtunkhwa province is not performing well on the economic front in contention with remaining provinces of Pakistan, the study aims

at finding answers to the reason behind this under development. On the financial front, Pakistan has been placed in the lower middle income countries of the world by the World Bank, a category of countries having Gross National Product (GNP) ranging between 1045 and 4125 USD but the Government of Pakistan vigorous efforts towards financial inclusion have still not yet produced positive results rather the results obtained are quite dismal and the statistics revealed that only 10.30 percent of the adult population was found to be bank account holders. It is way behind its South Asian counterparts at 33 percent and 41.4 percent in the case of lower-middle income countries of the world. The national statistics further reveal that 56 percent of the total adult population does not use any of the financial products while amongst the 36 percent savers, just 4 percent keep it with any bank or financial institution. When it comes to borrowing, 33.3 percent of the adult population borrows but just 4 percent of the total was found to be the subscribers of formal financial institutions. The National Saving Schemes launched by the Government of Pakistan caters to the saving needs of about 7.7 million people (Financial Inclusion Insights, 2014).

The agricultural sector which is the backbone of the economy and constitute 21 percent of GDP and its share in the total employment amounts to 60 percent of the total population, was able to receive only 6 percent of the total bank lending. This disproportionate relationship has led to devastation of the agriculture sector in Pakistan. This may explain with the help of Robert M. Solow's Theory of economic growth. In this type of situations, the result will be underutilization of capital if the interest rate becomes rigid somewhere above the level corresponding to the equilibrium capital-labor ratio (Solow, 1956). Without enough and easy access to

credit by the farmers, eventually resulted in serious handicap in access to agriculture-based equipment, seed, fertilizer and distribution channels. The inaccessibility of the former to the capital causes several other issues related to the economic development.

The current scenario in KP can be explained by the Robert Solow's neo-classical theory of economic growth. According to Solow (1956), the that a sustained rise in capital investment increases the growth rate only temporarily: because the ratio of capital to labor goes up. However, the marginal product of additional units of capital may decline (there are diminishing returns) and thus an economy moves back to a long-term growth path, with real GDP growing at the same rate as the growth of the workforce plus a factor to reflect improving productivity. A 'steady-state growth path' is reached when output, capital and labor are all growing at the same rate, so output per worker and capital per worker are constant. Neo-classical economists believe that to raise the trend rate of growth requires an increase in the labor supply and a higher level of productivity of labor and capital. At the same time differences in the pace of technological change between countries are said to explain much of the variation in growth rates.

The aforementioned situation in KP region reflects the dynamics of the Solow's economic growth theory. First, the due to war on terror the labor supply was not consistent. Many people migrated to the safe regions, that caused consistent reduction in labor supply in all sector of the economy in the region (Ali, 2010). Secondly, the capital investments were not sufficient to help economic growth across sectors. On the other hand, high illiteracy rates in the

region caused ignorance to the economic process and also the loan process is not well understood. This not only caused limitations of the capital investment but also the lack of technological advancement. The major reason of low economic progress in the region is attributed to the inaccessibility of the capital investment.

The KP region is culturally based on tribal system. The region predominantly has its own informal financial systems. Thus, the access to the formal banking system is limited. For this reason, it is important to study effectiveness of both formal and informal financial systems in order to enhance economic growth in the region.

Above scenario indicated an economic crisis in the region. Thus, it is important to find out the factors that cause economic damage in order to revive economic situation in the province. The researchers described several factors that are accounted for the poor economic conditions (Abadie, 2004; McCleary, 2006; Easterly (2001; Ali (2010; Barro, & McCleary, 2003). Easterly (2001) indicated the political instability is a factor that has influence the Pakistani economy. Ali (2010) stated that war on terror cause economic damage to the country. Barro, & McCleary (2003) highlighted the influence of the religion on the economic development of the country and many other researchers indicated several factors that are accountable for the economic disaster of the region. However, limited knowledge is available about the factors that are linked with economic slump in Khyber Pakhtunkhwa province of Pakistan. Thus, the current study focused on studying the factors in users of formal and informal financial system that influence the economic development of the Khyber

Pakhtunkhwaregion.

Coming to the core of this study is that the factor indicated above for determining the growth modify the perception and willingness of the people. It is fact that the social harmony and social integration are the key factors that are transmit to the people's willingness and motivation that trigger the positive and productive social bonding. It is obvious that the productive progress at large scale is directly related to the individual's willingness and attitude toward progress. Referring to the Adam Smith in 1776 following the theory of moral sentiments in 1759 where he introduced the term invisible hand the famous theory in classical economics he states that the production and distribution of resources are guided with self-interests of individuals. He rejected the structured and centralized economic system. He was of the view if the consumers are allow to choose and buy their product and producers are freely allowed to use factor for production and distribution then the market will get stable and efficient by itself because every individual will choose the commodities at their best choice and the producer will use resources efficiently to maximize their profit. If the Adam's opinion is taken rigorously it provides the base of this study where individual's attitude and behavior leads to their interests and hence to economic growth. Adam Smith in his manuscript wrote that the economic structure is in fact the mutual integration of individuals with their self-interests and the results of this mutual interdependence leads to wide spread benefits and no need is felt of having centralized planned economy. Moreover that invisible hand in aggregate result in productivity enhancement at large same argument is placed by Richard Cantillon (1755). The argument here is that if the people opinions and perception leads to economic growth then the

question arises here if the self-interest and beliefs are leading to the appropriate size of production and efficient resources allocation then it is obvious that the perception of the people and economic growth should be aligned. This study is an attempt to see people perception regarding economic growth is determined by their political, economic, religious and culture perceptions and they are highly associated.

The attempt that made in this study to investigate the impact on economic growth is different and special in the sense that instead of following the traditional estimation methodology is little different. Like time series analysis based on famous economic model such as Solow growth model here the estimation methodology is not time series rather it is perception of the people regarding growth just as done by Gabel & Whitten (1997). The idea of psychological growth is not new and propagated by (Bonanno, 2004;Maercker & Zoellner, 2004 and Tennen & Affleck, 2009). Gabel & Whitten (1997) argued that the motivation and willingness of public is important to form a structure particularly economic structure and public support and attitude is built on what they perceived about the economic growth and the policies of the government. He placed the example of Norwegian voters who rejected to be in EU in retaliation of refutation of Danish public to accept Turkey in EU in 1992. They concluded that the public opinion and attitude may affect the economic outlook of the system. Dalton & Eichenberg (1991) also were of the opinion that the public support and perception may lead to economic restructuring and integration but they found little empirical evidence. They further argued that the public support for integration is due to the macroeconomic variables like inflation but they evidently concluded that the public support and attitude is sensitive to economic conditions. Gabel & Whitten (1997)