



**Planning Commission**

Government of Pakistan

# CREATING A PLACE FOR THE FUTURE

Paper supporting the framework for  
Economic Growth Pakistan



# ENTREPRENEURSHIP & INNOVATION

# Foreword

Planning Commission has been charged with developing growth policy and managing the Public Sector Development Program (PSDP). The new Framework for Economic Growth (FEG) which has been prepared by the Planning Commission through research and countrywide consultation has been approved by the National Economic Council (NEC). It focuses on governance, markets, urban management, connectivity and engagement of youth and community.

The thrust of this new growth strategy is to develop the ‘software’ (institutions and governance) that are now viewed to be vital for the growth process. Pakistan needs sustained growth if it is to employ its youthful population and avoid social upheaval. This can only happen if Pakistan builds both a first class government and a globalised and competitive market. In essence it is about reorienting the role of government from controls and loss making parastatals to quality, magistracy, policy and regulation. This in turn will allow competitive markets to develop and provide a platform to idea-led entrepreneurs to innovate.

Plans in Pakistan have always talked of the ‘private sector’ wherein the policies seek to cultivate the private sector through subsidies, cheap credit, protections and many other incentives. This policy is preventing the development of *entrepreneurship*.

The FEG seeks a departure from this old policy to foster entrepreneurship and innovation in open competitive markets. In such markets, incumbents continually face the challenge of entrepreneurship to force cost and innovation competitiveness for the ultimate goal of consumer welfare. Entrepreneurs take risk and lead the innovation curve to force individuals, firms and nations to compete efficiently and creatively.

This report is an effort to diagnose the state of entrepreneurship in Pakistan, provide evidence for successful episodes, revisit global best practices and then come up with a set of actionable items that can ignite the entrepreneurial spark which is much needed in this country.

In order to begin, there is a need to recognize that past policies have not fostered entrepreneurship. Excessive government interventions have directed investment towards seeking favors from government rather than innovation. A leaner and sleeker government with fewer controls will allow for more imaginative policy and real innovative entrepreneurship. In addition, many policies and government initiatives for export and industrial development, and diversification have not produced a substantial change in the structure of exports and industry. Nor have these sectors shown the kind of growth required for sustained high growth that plans in the past have pushed for. It is time to move the paradigm! Entrepreneurship should enshrine policy to replace incumbency.

An examination of the Karachi Stock Exchange shows an insignificant number of listed entrepreneurs. In this day and age, government enterprises remain among the largest listed

companies. There are those that have had the advantage of government subsidy. It is no wonder that Pakistan's investment rate and the number of new issues remain at low level.

Thinking entrepreneurship chalks out a fresh approach to policy as under:

- Government functionaries must understand the new entrepreneurship-based approach. Policy and regulation must be made by serious professionals who understand global knowledge on this subject. Above all sector- and industry-picking by government should be seen for what it is—dispensing favors.
- The new regulatory frameworks must recognize that entry and exit are a part of good market development. It must seek to minimize costs of entry into markets as well as provide for exit. This will mean reducing the bias to incumbency. It will also mean placing risk of market decision on the investor and not the taxpayer.
- Government policy and regulation must maximize investment and innovative space. Markets and goods develop through ideas and individual initiative not through the heavy hand of government bureaucracy. Too many regulations and policies will retard entrepreneurial investments. The stifling of domestic commerce for example has most likely hurt entrepreneurship in a substantial way. Protection too has happened at the cost of innovation.
- Global research shows entrepreneurship happens in *walkable, dense and high-rise urban environments* that favor commerce and creativity. City administrations must yield to this new paradigm even if it means the reduction of privilege. Cities must have active downtowns where youth thrive in a culture of commerce, creativity, entertainment and constructive interaction. City management has to change in line with this vision to encourage entrepreneurship. The alternative is more of the same, low investment, low-growth environment. A whole new approach to planning and managing cities is required.
- A culture of learning, research and innovation has to be fostered in education everywhere. This will represent a whole new approach to education where control of learning has to be passed on to the most creative, away from the powerful and the bureaucratic. In other words, education must take a risk with new ideas and new initiatives.

Entrepreneurship must be given more space in the coming years through a more thoughtful policy and regulation. It must be given place in the value system by allowing merit to overtake privilege. Education too must give entrepreneurship space by replacing bureaucratic management by creativity, merit and risk-taking.

This is the first of the series “Shifting the Paradigm” to complement and elaborate the ideas presented in the FEG. We hope that these set of documents will explain the vision and the new set of ideas in the FEG. This information should allow the informed circles to develop a much needed debate on the important reforms outlined in the FEG and hence pave the way for implementation.

Lastly let me emphasize, governments cannot produce entrepreneurs! But it can do a lot by getting out of their way while providing them with a well-thought out regulatory and policy framework. And that is a large task which should be approached with learning, research and creativity.

I would like to acknowledge and appreciate the hard work of the Growth Team and staff of Planning Commission which was put in towards the preparation of this document. I extend sincere gratitude of Planning Commission to our partners (donors, civil society organizations, and academia) who have been a source of constant guidance throughout this process.

A handwritten signature in black ink, appearing to read 'N. Haque', written in a cursive style with a horizontal line through the middle.

**Dr. Nadeem Ul Haque**  
**Deputy Chairman**  
**Planning Commission**

**27 August 2011**

## Table of Contents

Executive Summary.....	7
Introduction .....	12
Enhancing Competition & Competitiveness .....	17
The Nature and Consequences of Market Distortion .....	18
Government Actions That Affect Attainment of a Level Field .....	21
Competitive Cities as Drivers of Growth.....	22
Promoting and Creating an Innovative Society .....	23
Creation and Commercialisation of New Knowledge .....	23
Diffusion and Absorption .....	24
Broader Investment Climate.....	24
Encouraging Entrepreneurship .....	25
Supporting New and Rapidly Growing Companies.....	25
Transitioning of Family Businesses to Business Families .....	27
Encouraging Rural Entrepreneurship.....	28
Creating Space for Urban Micro-Enterprises .....	29
Minimizing Transactions Costs.....	31
Transitioning to an Entrepreneurial Economy.....	33
Acting Assertively to Capture the “Demographic Dividend” .....	34
Engaging Diaspora Talents and Resources.....	36
Countering the Lack of Research, Expert Skills and Knowledge .....	37
Accelerating the Mobile Revolution .....	38
Supporting the Deployment of Distributed Energy Technologies .....	39
Improving Governance & the Legal Framework.....	41
Conclusion.....	44
Annexure 1.....	45
How Entrepreneurship Impacts Economic Development.....	47
Annexure 2.....	50
Individuals Consulted in the Preparation of the Report .....	50





## Executive Summary

For six decades Pakistan has faced and tried to overcome many challenges primarily arising from conflicts and natural disasters. Despite many obstacles the country's economy has grown steadily. At critical junctures, successive governments have adopted strategies suited to the circumstances of the day, and the nation has developed steadily due to these efforts. Yet, as a consequence of the reactive nature of policy formulation and implementation, government institutions are conditioned to think in terms of projects instead of growth strategies. Even though the greatest problems are that of security and inadequate energy supply, lack of contract enforcement, and outmoded land record system<sup>1</sup>, there is a need for creating space for making entrepreneurship and innovation flourish.

Today, Pakistan confronts a new round of challenges and urgent demands. It is precisely at this moment—in the aftermath of a devastating flood and with security concerns—that the need to change the discourse about the country's development has become most apparent. Reactive tactics and dependence on external aid are not helping Pakistan to develop or realise its potential.

In order to navigate on the path to economic success, Pakistan must reinvent the role of government and ensure the rule of law. No society can progress without the rule of law, which includes providing security, law and order, and a legal and judicial system that enforces contracts and protects property rights. Government must divest itself of discretionary power as society cannot progress without good governance and the rule of law.

Trade and open borders have made nations vulnerable and accountable to competition from other states that have managed to replace discretionary decisions with rules based decisions as the guiding principles of their economies. We must steer the government away from its discretionary role and remake it so that the rules apply equally to all. What Pakistan needs is effective democracy and rule of law.<sup>2</sup>

The government and the private sector must work together, where the government offers policies, regulation, protection and facilitates to the private sector to finance investments, build and own assets, and manage them efficiently. Countries that move ahead and achieve growth focus on human development do business with other countries, and attract foreign investment. To realise such a potential, Pakistan's political and business leaders must not only meet present demands, but also create a space for the future. 'Space for the future' is not a poetic or fictional concept. It means abandoning the soviet-inspired socialist notion of the need for a government plan and adopting the Hayekian and Smithian notion that economies can work best if individuals are given the space in which to conduct their affairs. This is why sustained and sustainable development cannot come from a collection of projects, no matter how well intended. A new approach is needed where opportunity is available to all; cities are vibrant and dynamic; entrepreneurship and innovation thrive; good governance is practiced with minimum invasion into private affairs; civil and property rights are protected and enforced; and, youth are educated and involved in innovative and productive activities.

It is only within the space of private initiative that Pakistan will find the solution to the twin challenges of demographic expansion and foreign competition. Neighbouring competing nations are unleashing their economic potential by freeing and at the same time protecting private initiative.

<sup>1</sup> 'State of Competition in Pakistan', Competition Commission of Pakistan Islamabad, Pakistan, 2009.

<sup>2</sup> NU Haque, 'Entrepreneurship in Pakistan', Working Paper, Pakistan Institute of Development Economics, 2007.



This has had the twin result of producing the jobs needed for political and economic stability and at the same time has slowed the population explosion as people are now able to invest in assets as a way of securing their futures rather than investing in the creation of offspring. Pakistan must follow this trend to become a nation of entrepreneurs, not a nation of demographic breeders.

Creating economic space is not just a metaphor—it calls for a plan of action. An action which is geared towards removing obstacles to entrepreneurship—that is, to allow investments that have the potential to provide needed services to a youthful and growing population. It also means supporting entrepreneurs as they seek to build innovative high-growth companies—even when those new businesses challenge the dominance of existing firms.

Government must facilitate an environment for conceiving, engineering and building new products and services for the global marketplace, where Pakistani producers are underrepresented, and for the domestic marketplace, which does not serve consumers adequately. ‘Facilitate’ means the government must not ‘pick’ sectors or offer subsidies and support incentives. Picking sectors and winners has produced a polluted economic environment in which some rent-seekers who can best lobby the government are the winners rather than the winners being those who can best supply end-user needs.

The government should provide a level field where research and development is productive and worthwhile; eliminate laws and policies and punish practices that promote rent-seeking; remake cities so they are focal points for creativity, not flashpoints for conflict; create mechanisms to support and empower civil servants who push back against powerful interests and overcome institutional inertia; reform the civil service; eradicate corruption; monetise perks and provision of land; prevent personal use of public assets; get out of the business of developing land; sweep away the barriers to trade that threaten to strangle the economy in the snares of anti-competitive practices.

Not all the responsibility for economic success lies with changes in the government. A change of business attitude is also needed – a recognition that changes are inevitable and reliance on government is minimal. Businesses must satisfy consumer preferences, not seek favours, special treatment or rents. They should look beyond short-term interest and local advantages, and build foundations for organisations with the potential to compete over the long-term anywhere in the world. Similarly, businesses must also seek advantage not in regulatory protections that stifle social development and encourage rent-seeking, but in creating innovations that accelerate productivity gains, market growth and overall economic growth.

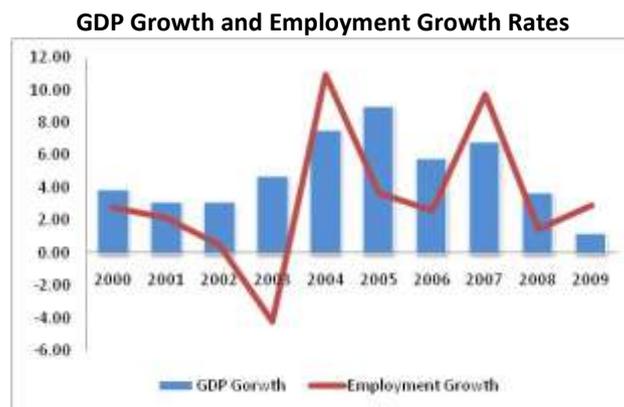
Conditions that allow markets to thrive include a conducive environment where economic agents are able to operate, compete, and interact with each other on a level playing field<sup>3</sup> (which is the same as having the rule of law such that everyone incurs the same cost of doing business). This creates the environment essential for private initiatives and businesses to realise productive efficiency and contributes substantively to growth and development.

A functioning market without government intervention (with competent regulation as needed) and protected from anti-competitive practices is fundamental to achieving efficiency and entrepreneurship, resulting in overall productivity.

<sup>3</sup> ‘State of Competition in Pakistan’, Competition Commission of Pakistan Islamabad, Pakistan, 2009.

Many of the factors that hold back GDP growth rate are institutional or policy-based in nature, and require correctional measures rather than the application of large amounts of financial resources. Pakistan has many entrepreneurs, but innovation and risk-taking is severely constrained by the intrusive role of the government in the marketplace.

Pakistan's population is growing at an annual rate of about 2 per cent. The age structure of the population and a faster entry of women into the workforce are causing the labour force to increase at 3.6 per cent a year. Since Pakistan's employment to GDP elasticity is 0.5, its GDP must grow at more than 7 per cent to absorb the flow of workers into the labour force and maintain the current unemployment rate. For Pakistan to become a middle-income country, GDP must grow at a sustainable rate of 8 per cent for more than 30 years—a daunting challenge, which can be overcome.



Source: Economic Survey of Pakistan 2009-10

If economic growth is not leveraged on a higher trajectory, then the coming demographic changes will imply rising unemployment, shortage of assets and difficulties in competing with neighbouring South Asian countries, which are also benefiting from younger populations.

Cognizant of today's demands as well as those of the future, this study argues that developing a culture of productive entrepreneurship in Pakistan requires immediate actions by the Government of Pakistan to:

- Enhance Competition and Competitiveness – Despite serious but sporadic initiatives aimed at market liberalisation, Pakistan's economy remains dominated by the government. It is important that all government ministries and departments carefully examine the rationale behind and consequences of direct involvement in the economy, and act assertively to eliminate programmes and policies that crowd out private business initiatives and create perverse incentives. The government should phase out economic subsidies and protections that are currently operative, and implement a plan to eliminate laws and policies that promote unproductive entrepreneurship and rent-seeking. While the push-back from incumbent firms against a comprehensive competition and competitiveness strategy is likely to be intensive, the alternative is economic stagnation—an outcome ultimately detrimental to all.
- Promote Innovation and Create an Innovative Society – Pakistan needs innovation to bring about sustained economic growth. Without the required educated and skilled workforce it cannot attain that innovative threshold. Lack of innovative spirit in the public sector and even in the country's larger private enterprises is not just a matter of insufficient resources or ill-conceived policies, but more of an unsupportive culture.

- Encourage Entrepreneurship—which comprises innovation and taking prudent business risks. When entrepreneurship is allowed to take root and flourish, it results in high growth rates and opportunities open up for all segments of society, including the poor. Pakistan has many entrepreneurs, but innovation and risk-taking is redirected to perverse ends by the intrusive role of the government in the marketplace. The state of competition in many Pakistani industries is such that policies protect and subsidise incumbents, inducing the entrepreneurs to focus their energies and limited capital towards rent-seeking activities rather than into productive entrepreneurship. A key objective of the New Growth Framework is to create an environment conducive to productive rather than dissipative entrepreneurship which would lead to development of small-scale entrepreneurial ventures and innovative, high growth firms. The system of incentives (laws and policies) that promote rent-seeking must be dismantled and reforms (including legislative changes) to encourage and develop entrepreneurship are required.<sup>4</sup>
- Minimise Transactions costs—While Pakistan is rich in talent and has ample capital resources, it suffers from a significant trust deficit that not only undermines the relationship between citizens and government but also impedes the conduct of business by increasing the cost of transactions. Building trust takes time. Consequently the government should mitigate adverse consequences of the trust deficit by decreasing transactions costs in its dealings with citizens and increasing the transparency of government decision-making. In practical terms, this means increasing connectivity and seizing every available opportunity—in particular, opportunities created by the availability of information and communications technologies—to make information easily available to citizens and to improve the efficiency of government and to build infrastructure, which reduces costs. This requires a change of culture at the government level.
- Physical Space for Entrepreneurship – Pakistan needs creative cities. In Pakistan, land distribution and city zoning and management of public assets have evolved to encourage rent-seeking development. Land mafias are carving up cities for their own vested interests. Cities are being prevented from becoming clusters of commerce and cultural activities. Cities grow when they are allowed to function as decentralised, coherent administrative units that advance commerce, social interaction and cultural development. It is then that they become engines of economic, social, and human growth. The government must properly define and decentralise city limits and give municipalities ownership to their land and resources. Zoning laws need to move away from emphasising development of upper class houses to recognising the diversity of the various functions of a city, allowing for the development of city centres for dense mixed-use, especially for education, entertainment and cultural activities.
- Deregulate Domestic Commerce—Pakistan’s economic policy has been and continues to promote growth through a ‘mercantilist’ approach where domestic commerce is heavily regulated. Mercantilism is a mode of economic philosophy that was appropriate for seventeenth century Europe and even then it had its detractors. It has been replaced with Smithian and Hayekian approaches that encourage innovation and entrepreneurial activity. We must steer away from the non-productive present to embrace the future—a future where the government does not dictate which sectors or businesses will thrive but rather allows competitive forces to act as the filter of economic genius. Domestic commerce either employs most of the urban poor or offers them self-employment opportunities and therefore deregulating it ought to help in alleviating poverty.<sup>5</sup>

<sup>4</sup> NU Haque, ‘Entrepreneurship in Pakistan’, Working Paper 2007:29. Pakistan Institute of Development Economics, 2007

<sup>5</sup> Ibid

- **Protect Intellectual Property**—When firms and entrepreneurs can rely on swift adjudication of property rights and contracts they will invest in research and development, patents, copyrights and trademarks, which allow them to invest in organisation capital and brand development to overcome problems of asymmetric information, which otherwise cause market failures. Put more simply Pakistan must create an economic safe-zone in which ideas and concepts can grow. Such a safe zone reduces uncertainty and lowers information costs borne by consumers and therefore encourages trade and exchange. Contract sanctity and intellectual property rights should be protected, with swift adjudication of conflicts, to encourage investment in R&D and foster innovation and prudent risk-taking.

### Property rights (including intellectual property) Rank out of 139

Countries	Property Rights	Intellectual Property Protection
<b>Pakistan</b>	<b>107</b>	<b>86</b>
<b>India</b>	61	66
<b>Indonesia</b>	84	58
<b>Thailand</b>	89	84
<b>Malaysia</b>	41	33
<b>China</b>	38	49

Source: Global Competitiveness Report 2010-2011

By acting simultaneously on all fronts the government can promote efficiency, investment, innovation and entrepreneurship necessary to deliver essential goods and services to its citizens, encourage the development of domestic markets, and drive sustained economic growth. In doing so, it will achieve broad-based social development and realise greater economic growth and lower poverty incidence, in the long-term.



## Introduction

Economic growth and progress have been seriously impeded in Pakistan because of a policy environment that is unfriendly to productive entrepreneurship. This report focuses on how policy can be adjusted to let entrepreneurship play a greater role in the economy. Growth evolves as a spontaneous process which results when people take resources and arrange them into more valuable products and services. Growth is a result of knowledge accumulation, entrepreneurship and productivity. Progress is the result of refashioning crude manifestations of nature into an embodiment held in the minds. Knowledge and entrepreneurship are not just catchwords of the modern age but technical terms denoting systems that process information and transpose old structures into new—called as ‘translations and transformations’. Innovation and ideas drive growth by amplifying and stretching what entrepreneurs have. In this view, growth to a large extent comes from new ideas which entrepreneurs take the risk of bringing to market.<sup>6</sup>

While Pakistan ranks relatively at par with regional economies in its infrastructure (hardware of economic growth) it however performs poorly in the utilization of its existing assets – software of economic growth, which includes organisation of institutions, better governance and human capital that is in line with globally successful experiences. The software enables to better manage what is currently available. It supports innovation in developing better uses of new and existing resources and assets, which generate greater productivity.<sup>7</sup>

Economic software is of course a metaphor but it is also a precise notion of how economic systems work. Economies are information processing machines. What they strive for is a sort of balance between what people put in and what they get out. Centralise control lacks the information processing capacity to ensure a quality of social accounting that provides people with the motivation to provide effort. This is why growth requires a renewed focus on firms—small and large—and consumers for the desired economic equilibrium. The system of incentives that a country sets up in its governance mechanism can either promote healthy entrepreneurship, leading to growth and prosperity, or to rent seeking. In the latter case, a society gets stuck in low-growth, poverty trap.

Schumpeter sees economic development as a continuum of series of new processes, new markets, new sources, and new organisations all of which are a product of entrepreneurial and competitive activity.<sup>8</sup> This innovative and entrepreneurial process filters away the unproductive activities through a process of trial and error in turn reallocating labour and capital into new productive enterprises. There is abundant evidence that productivity of new businesses exceeds that of old businesses that they replace. Thus entrepreneurship, enterprise formation and letting firms swiftly file for bankruptcy and sell off assets, is essential.<sup>9</sup>

Sustaining economic growth is determined by the way societies deal with advances in technology, taking well calculated risks, innovating and industriously competing. Sustained growth is a process of continual transformation. Economic progress that has occurred since the Industrial Revolution would not have been possible if people and nations had not undergone these changes. Economies that do not transform themselves fall off the path of economic growth, which generates prosperity and

<sup>6</sup> Grossman, Gene M & Helpman, Elhanan (1991). "Endogenous Product Cycles" Economic Journal, Royal Economic Society, vol. 101(408), pages 1214-29, September 1991

<sup>7</sup> NU Haque, 'Towards a New Development Approach', Planning Commission of Pakistan, 2010.

<sup>8</sup> H Barreto, 'The entrepreneur in microeconomic theory', London: Routledge, 1989.

<sup>9</sup> NU Haque, 'Entrepreneurship in Pakistan', Working Paper 2007:29. Pakistan Institute of Development Economics, 2007

alleviates poverty. On the other hand, economies that foster or rapidly embrace technological change grow faster.

Governments can increase the rate of growth by creating economic institutions and incentives to benefit the citizens. Government policies should incentivise the creation of technology, increase the rate of knowledge absorption from abroad, and encourage innovation and community collaboration—in other words, build and augment social capital through better governance and transparent laws.

The other dimension of economic software is the market-based system, which establishes prices to guide the economy to most efficient production and allocation of goods and services, based on free interactions between buyers and sellers. There are, however, some market failures that undermine efficiency, for example, externalities and asymmetric information. Policies which embrace openness and organisational mechanisms for tapping efficiency and productivity generate accelerations in economic growth. Conversely, policies which stifle and choke innovation, by protecting or favouring particular industries or firms, slow the rate of growth and suffocate prosperity and development.

Many view aid and aid-inspired policy as well as centralised and macro approaches to development as a failed strategy to achieve the promise of development.<sup>10</sup> In this view, growth happens when policy and management at every level in the economy turns entrepreneurial. Yet this is a limited view as not all entrepreneurship is fruitful for the development of society. Sometimes entrepreneurship can benefit the individual at the cost of the collective.

In Pakistan the potential of new ideas is vastly underestimated, especially for a nation whose promise has yet to be fulfilled. Turkey, South Korea, and Thailand were all roughly on a par with Pakistan until the 1970s. Pakistan has progressed substantially in the four decades since then, yet these three countries—and others similarly endowed—have surged even farther ahead in terms of human and economic development.

While the Public Sector Development Program (PSDP) in Pakistan focused heavily on the hardware of economic growth, the government offerings such as tariff protections, export subsidies, loans, cash and land grants, purchase of goods, tax concessions, etc has undermined the planned developmental outcomes. According to the New Growth Framework, the current planning system must be dismantled and replaced with a paradigm that should promote transparent and competitive markets, improved management of cities, enhanced connectivity between people and places and a greater youth and community engagement for making growth process more inclusive.<sup>11</sup>

It is unfortunate that recent trends have not been favourable to Pakistan. While entrepreneurship and innovation have driven an upsurge in prosperity in many parts of the world, the Pakistani economy has been stuck in low gear. With markets suppressed by government action (and inaction), industries serving the domestic market have failed to seize new opportunities both inside and outside the country. Intensified flows of overseas direct assistance have deepened reliance on government, rather than on markets, as a source of opportunity. Longstanding shortcomings in the country's educational infrastructure and 'management software' (i.e., using assets efficiently) have remained far from a solution. The result is a society in which present interests have been protected to such an extent that the future has been obstructed.

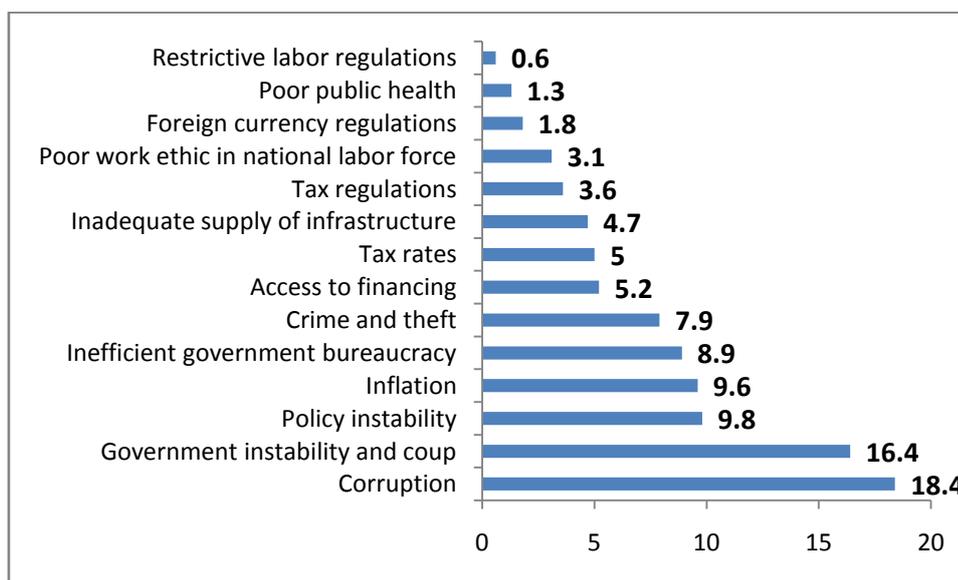
<sup>10</sup> There are aid effectiveness initiatives which call for more accountability from all, including recipient governments.

<sup>11</sup> 'Pakistan Framework for Economic Growth', Planning Commission, Islamabad, Pakistan, 2011.

Pakistan needs to install and launch the software of economic growth in both letter and spirit. Specifically, there is a need to look at productivity; efficiency; provide secure environment to attract private investment; attract skilled professionals from abroad; free up markets to encourage commerce and competition; pass reforms for better governance; decentralise decision-making; promote entrepreneurship—where firms and individuals take risks to bring innovations to market; build human capital (educate and train the youth) and tap the talents of women to drive growth in the service sector; build venues for knowledge spill over (in cities, civil institutions, universities and forums such as trade shows and conferences where academia, media, businesses and entrepreneurs converge) to foster production and dissemination of ideas; improve connectivity (incentivise the development of technology and transportation infrastructure); provide incentives for development of new markets (for example, markets for trading options, futures and forward contracts to hedge risks); and, empower communities and grass-root organisations to address health, poverty and gender issues.

A recent growth diagnostics analysis of the Pakistani economy undertaken by a team at the Pakistan Institute of Development Economics and National University of Science & Technology (NUST) confirms this assessment. The analysis finds ‘the failure of governance and that of institutions to be the binding constraint to growth’, in Pakistan. It further expounds ‘rent-seeking in the shape of licenses, subsidies, and tariff protection has not allowed the development of a competitive environment which is essential for innovation to occur’.

**The Most Problematic Factors for doing Business**



Source: World Economic Forum, Global Competitiveness Report 2010-11

With these and similar findings in mind, this report offers an assessment of the state of entrepreneurship and markets in Pakistan and informs government policy and planning. This study is based on the following premises:

- Entrepreneurial talent is abundant and exists everywhere.
- Productive entrepreneurship would direct talent effort and capital toward overall social development.



- Removing barriers to entry and exit will facilitate a new breed of entrepreneurs who are more productive.

General perception about economic growth is that it comes from large plants and factories and government projects and services. This is understandable as the only feasible and attractive target of government planning is large industry. Government does not have the information or the ability to initiate projects on a smaller scale and thus neglects a critical structure of the economy. It is no surprise that the informal and small scale sectors that dominate Pakistan's economy have been ignored in development policies. Almost 40 per cent of business transactions take place in the informal sector and yet small enterprises continue to face unfavourable treatment.<sup>12</sup>

Neglect of the small scale manufacturing by the government is evident from the fact that even today growth rate of the sector is not computed on regular basis (the way it is done for large scale sector) by the Federal Bureau of Statistics. Small scale and informal sectors are more dynamic and productive than what government figures show. It is the small-scale sector that is the breeding ground for innovation.<sup>13</sup>

Informal and small scale sectors are labour-intensive and have dominated employment in construction, wholesale, retail trading, hotels, transport, communications and storage industries in urban areas. Thus, government policy must facilitate entrepreneurs to establish, formalise, and grow their enterprises with minimal difficulty. This, however, does not mean that this form of entrepreneurship be institutionalised.

A subset of productive entrepreneurs—those who create high-growth firms—make a significant and critical contribution to development. Most entrepreneurs start small and stay that way. Productive entrepreneurs who create high-growth companies (sometimes called 'gazelle' firms) play a significant role in social development through job creation, industry revitalisation, and philanthropic activities. Thus, it becomes an important socioeconomic priority to ensure that high-growth firms have the space to form (in urban and rural areas) and the resources to develop.

If innovative ideas are to be implemented in small setups, and the evidence being that small firms account for only a negligible part of the R&D being actually undertaken, then there is a need to identify the source of innovative ideas that flourish within small firms. Griliches suggests knowledge spills over from a firm or research institute that transfers knowledge to another firm that commercialises it.<sup>14</sup> The view that knowledge spill over generates increasing returns and hence economic growth is supported by Romer<sup>15</sup> and Krugman<sup>16</sup>. Schumpeterian innovation occurs when knowledge is used to create a more productive asset, and firms discovering and employing higher-quality assets replace firms using outdated assets, thus creating continued economic growth.<sup>17 18</sup>

Putting Pakistan's economy back in a position to reap the dividends of global growth in the 21<sup>st</sup> century will require nothing short of a fundamental shift in the discourse about the country's development. Projects focused narrowly on short-term needs will remain no more effective in reinvigorating Pakistan's economy than will recipes from the past—from 1960s-style large

<sup>12</sup> In the Soviet Union close to half the national agricultural output came from family gardens which competed with state-run collective farms that benefited from massive subsidies but produced little.

<sup>13</sup> NU Haque, 'Entrepreneurship in Pakistan', Working Paper 2007:29. Pakistan Institute of Development Economics, 2007

<sup>14</sup> Z Griliches, 'The Search for R&D Spillovers', *Scandinavian Journal of Economics*, Wiley Blackwell, vol. 94, 1992, pp. S29-47

<sup>15</sup> P Romer, 'Increasing Returns and Long-Run Growth', *Journal of Political Economy*, vol. 94, No. 5, 1986, pp. 1002-1037

<sup>16</sup> P Krugman, 'Geography and Trade', MIT Press, Cambridge, 1991

<sup>17</sup> E Helpman and P Krugman, 'Trade Policy and Market Structure', MIT Press, Cambridge, 1989

<sup>18</sup> E Dinopoulos, JF Oehmke, and PS Segerstrom, 'High-Technology-Industry Trade and Investment: The Role of Factor Endowments', *Journal of International Economics*, vol. 34, no. 1-2, 1993, pp. 49-71.



infrastructure projects to 1990s-style liberalisation. What is needed is a redirection of investment and reform efforts from the hardware (bricks and mortar infrastructure) to the software (high level human capital, better management of assets, good governance, etc.); from external aid to focus on developing domestic markets and enterprises; and, from rent-seeking and unproductive activities to productive and innovative entrepreneurship.

Planning for the future in Pakistan will have succeeded not when donor organisations have disbursed funds or government agencies have expended their budgets, but when more people believe that they have a stake in a shared future that is as valuable as dividends derived from protecting the present. Such a belief, when translated to action, is a prerequisite for Pakistan's prosperity, just as for any country.

## Enhancing Competition & Competitiveness

Greater globalization has implied that economic control now lies substantially with non-government actors. If the private sector is to be the engine of economic growth, the government's role in influencing private sector decisions must also evolve so that socially desirable outcomes are achieved. Market reform in Pakistan has been put off for too long. For the new growth framework to work, competition must lead.

Pakistan's Rank and Score – Global Competitiveness Index				
	2007-08	2008-09	2009-10	2010-11
Rank	92	101	101	123
Out of	131	134	133	139
Score	3.77	3.65	3.58	3.50

Source: The State of Pakistan's Competitiveness Report 2010-2011,

Over a period of four years (2007-11) Pakistan's Rank in Global Competitiveness Index has fallen drastically, despite only a modest fall in its score. Yet there is a paradox here as Pakistan scores well on the index of economic freedom, well ahead of India.

The economic freedom numbers suggest that Pakistan has the necessary background for growth whereas the competitiveness statistics suggest that something is preventing Pakistan from realising its full potential. The problem may reside in the fact that market reforms in Pakistan have been put off for too long. For the new growth framework to work, competition must be in the lead. An essential characteristic of an entrepreneurial economy is prevalence of competitive markets. Markets are the part of the economy in which forces of demand and supply, and the resulting prices, determine efficient production and allocation of goods and services. The internal operations of government, military, and large companies lie outside markets. Within those domains, resources are allocated by an administrative mechanism—for example, via the Public Sector Development Program—not by a market mechanism. For markets to serve the public interest, they must be accountable to the rule of law and government supervision and to consumer demand and subject to competitive pressure, in particular from new firms entering the market. Yet as important as all these obvious manifestations of institutional infrastructure are, it is the willingness of people to play within the rules of the game. This is a challenging proposition that requires a change of mindset across the board and a strong commitment from all levels of the government.

Ensuring that competition occurs in markets, should be an urgent government priority because markets that function effectively can meet Pakistan's critical need for economic opportunity and vital goods and services, such as reliable energy, accessible financial products, and affordable housing. Currently, markets in Pakistan are not adequately competitive and are not providing economic opportunity and vital goods and services efficiently. The primary reason for this is that entrenched business practices and government policies have stifled competition and innovation in relevant industries—notably banking, cement and construction, power generation and transmission, sugar, automobiles and fertiliser.<sup>19</sup> With the notable exception of mobile communications (an industry addressed in detail, later in this report), nearly every market in Pakistan is structured in a way which is disadvantageous to entrepreneurs and discourages innovation because the rules of the game are designed by vested interests.

<sup>19</sup> A Ghazanfar and NA Kazmi, 'State of Competition in Pakistan', Competition Commission of Pakistan, Islamabad, 2009.



Pakistan's economy is riddled with rules and regulations that may once have addressed a real economic or social issue, but now only too often serve merely to create arbitrary obstructions to doing business. The dissolution of such impediments is always time consuming and frequently requires the payment of substantial bribes or gifts to officials.

### Bureaucrats in Business

Sectors	Examples of Public Sector Entities
<b>Crop Sector</b>	Trading Corporation of Pakistan, Pakistan Agricultural Storage and Services Corporation, Cotton Export Corporation of Pakistan, Rice Export Corporation of Pakistan, National Fertilizer Corporation
<b>Livestock</b>	Livestock and Dairy Development Board
<b>Fisheries</b>	Fisheries Development Board
<b>Mining</b>	Pakistan Mineral Development Corporation, Lakhra Coal Mines
<b>Transport</b>	National Logistics Corporation
<b>Aviation/Ports</b>	Pakistan International Airlines Corporation, Civil Aviation Authority, Karachi Port Trust, Port Qasim Authority
<b>Railways</b>	Pakistan Railways
<b>Retail</b>	Utility Stores Corporation
<b>Road</b>	National Highway Authority, Frontier Works Organisation
<b>Electricity</b>	WAPDA, PEPCO, KESC, Peshawar Electric Supply Company, Faisalabad Electric Supply Company, Jamshoro Power Company Limited
<b>Industry</b>	Pakistan Engineering Company, Pakistan Steel Mill, Pakistan Industrial Development Corporation, State Engineering Corporation
<b>Construction</b>	State Cement Corporation of Pakistan, FWO, National Engineering Services Pakistan, National Power Construction Company
<b>Insurance</b>	State Life Insurance Corporation, Reinsurance, Pakistan Insurance Corporation, National Insurance Corporation
<b>Finance/Banking</b>	National Bank of Pakistan, Zarai Tarqiati Bank Limited, National Investment Trust Limited, First Women Bank, House Building Finance Corporation
<b>Communication</b>	Pakistan Telecommunications Corporation Limited, Pakistan Television, Pakistan Broadcasting Corporation
<b>Oil &amp; Gas</b>	OGDCL, Sui Northern Gas Pipe Lines, Sui Southern Gas Pipe Lines, Pakistan State Oil, National Refinery Limited, Pak Arab Refinery Limited, Pakistan Petroleum Limited,
<b>Housing</b>	Pakistan Housing Foundation, Defense Housing Authority
<b>Shipping</b>	Pakistan National Shipping Corporation
<b>Postal</b>	Pakistan Post Office
<b>Others</b>	Printing Corporation of Pakistan, Pakistan Tourism Development Corporation, Ghee Corporation of Pakistan

### The Nature and Consequences of Market Distortion

While the state of competition varies significantly among industries, certain generic distortions are present in most markets in Pakistan.



## Excessive Government Engagement in the Economy

The government needs to shift its role in the development process from hands-on engagement to a facilitator of fair and lawful private action. In response to inflows of donor funds sustained over decades, the very functions of government in Pakistan have evolved toward direct engagement in development and away from the essential magisterial functions of government, including maintenance of law and order, enforcement of property rights, and application of judicial procedures. This ‘big-push’ approach to development that was adopted in the early years stands irrelevant now. As a consequence, the quality of governance in the country—notably, professional standards in civil service—has declined and rent-seeking and corruption have been reinforced.

### Ubiquitous ‘Rent-seeking’

Business leaders have become conditioned to an environment in which short-term gains from seeking advantage from the government are systematically greater than longer-term gains from identification and exploitation of genuine economic opportunity. Haque<sup>20</sup> observes that when wealth transfers can be achieved through government licenses, policies and directives, entrepreneurial efforts will be directed toward gaining such transfers. Economic agents will expend efforts toward attempting to influence government actions in their favour in order to accumulate wealth. Examples of such government provided wealth transfers are conferring of a monopoly through a license, obtaining resources at below the market prices (e.g., publicly provided land at cheaper rates than market to influential groups), protection from competition (e.g., restriction of number of players in a market) and the manipulation of government subsidies, tariffs and tax policies. In all such cases, the government directive or policy confers wealth on an individual often at the expense of the rest of society.<sup>21</sup>

In this way, government policies that encourage rent-seeking and short-term gain act as a reverse tax in the sense that is imposed on the rest of society to favour one or more interest groups. Once in place, the favoured group(s) will tend to expend real resources towards unproductive entrepreneurship. When the returns to rent-seeking are sufficiently large, potentially productive entrepreneurs will be drawn away from genuine entrepreneurship towards government patronage.

### Inadequate Incentives to Innovate

The most negative consequence for the economy of rent-seeking behaviour is that it undermines the incumbent firm’s incentives to innovate and the willingness of investors to take prudent business risks. The banking industry in Pakistan offers a prime illustration of this phenomenon. Pakistan is the world’s least banked nation. Depending on the measures used, only between 4 per cent and 15 per cent of the population of Pakistan has access to financial services. At the same time, Pakistani banking industry is among the most stable and profitable industries in the region. Financial service innovation is possible, of course. Leading banking firms are undoubtedly capable of developing new products that could lead to greater financial inclusion and overcome historical neglect of agricultural credit, small and medium enterprise (SME) financing, and housing finance in particular. However, according to the Competition Commission of Pakistan ‘the solution to the chronic problems of policy neglect and bank complacency must be sought outside the banking industry. No amount of exhortation or incentives to banks has worked in the past sixty years because the opportunity costs

<sup>20</sup> NU Haque, ‘Entrepreneurship in Pakistan’, Working Paper 2007:29. Pakistan Institute of Development Economics, 2007

<sup>21</sup> Ibid

of entering [agricultural credit, SME financing, and housing finance] markets are clearly too high [due to] the existence of monopoly rents in the shape of high spreads between deposit and lending rates accruing elsewhere in more lucrative markets from which there is no competitive compulsion to diversify'.<sup>22</sup>

Government's direct engagement in financial markets has the effect of distorting the environment for competition. In particular, large amount of public spending draws capital away from the private sector. Although each industry has its own competitive dynamics, innovation is hindered in many sectors of the economy by the absence of competition and 'rents'.

### **Rent-seeking Land Development**

Land development and allotment in Pakistan has been a rent-seeking opportunity involving all those in power including civil servants, judiciary and the army. This may have become the single most important impediment to development. A major wealth accumulation strategy that has gained ground over the years is the provision of subsidised land to those with power. With profits from the land-game being higher than from productive business activity land prices have risen drastically over the years. This has adversely influenced entrepreneurship by increasing the cost of doing business as acquiring business premises became costlier; shifting the interest of businessmen away from entrepreneurial activities; and, by locking in funds that could have been available for entrepreneurial activity.<sup>23</sup>

### **Policy Proposals Related to Markets**

#### ***Enhancing Competition***

Competition Commission of Pakistan, Securities and Exchange Commission of Pakistan and State Bank of Pakistan should:

1. map out, with respect to goods and services, the subsidies and protection currently operative, and
2. implement a plan to eliminate these distortions

The government should provide all necessary resources to ensure that the above objectives are met which involves funding the Competition Commission and ensuring that it has the authority to make decisions independently. The Competition Commission should be the body responsible for the attainment of a level playing field in Pakistan's markets. As such, the government should consult with the Competition Commission when framing or drawing up industrial and trade policies. This is particularly important when tackling privatisation and granting concessions.

#### ***Strengthening market institutions***

As a general policy, the Government should refrain from entering into agreements with vertical industries on product pricing, costs, distribution, and the level of production. Contract enforcement needs to be strengthened through the efforts currently under way to improve the functioning of courts. Bankruptcy laws that are consistent with international norms must be institutionalised and

<sup>22</sup> 'State of Competition in Pakistan', Competition Commission of Pakistan, Islamabad, Pakistan, 2009.

<sup>23</sup> NU Haque, 'Entrepreneurship in Pakistan', Working Paper 2007:29. Pakistan Institute of Development Economics, 2007

should bolster standards of corporate governance. Regulatory institutions should be strengthened while the quality and reach of financial service delivery must be improved. The existing regulatory framework for non-bank financial institutions should be rationalised for ease of entry and exit, and their prudent functioning.

## Government Actions That Affect Attainment of a Level Field

Like entrepreneurs, not all market institutions are created equal. The mere existence of a market does not, in itself, indicate the presence of economic dynamism. In societies where extensive government involvement distorts market signals, competition is dulled and markets stagnate. In the long term, societies with adaptable market institutions tend to edge out those with rigid market institutions.<sup>24</sup> Thus, improving the environment for competition is not a matter of policy aesthetics—it is an essential element of adaptability and effective competition for any country in the 21<sup>st</sup> century. The key to competition policy is the notion of a ‘level playing field’ for market participants. A ‘level playing field’ in the market is one in which companies (and countries, for example, in the realm of international trade) can compete fairly with each other in a rule-based environment where no one enjoys, or is given, any special advantage. All competition agencies regard the attainment of such a level playing field in individual sectors of the economy and, indeed, in the economy as a whole, as their primary responsibility.<sup>25</sup>

The Competition Commission of Pakistan identifies four mechanisms by which government actions impede the attainment of a level playing field. First, the overall duty structure on imports varies enormously between raw materials, intermediate inputs, and no clear rationale is discernable in terms of the objectives that are being pursued. The endless list of exceptions, exemptions and variations defy the central principle of efficient taxation in which similar activities should be similarly taxed. The actual impact of high tariffs is the widespread abuse in the form of smuggling or informal imports. The government in the meantime has become dependent on import duties as a vital source of revenue and is reluctant to rationalise them. Secondly, in order to attract foreign direct investment (FDI), tax holidays and tax-free zones have been the modus operandi in Pakistan, as elsewhere. But tax concessions for FDI, aside from leading to significant revenue losses, also lead to unevenness in the domestic playing field.

Third is the forced subsidisation of the production and sale of staples in household budgets—wheat flour and sugar in particular. However, the actual impact of subsidies on production and prices is often unpredictable and the situation is rendered even more complicated in an inflationary environment. Finally, public procurement procedures have a major impact on competition in the country. Prime examples are the Frontier Works Organisation (FWO) and the National Logistics Cell (NLC), two entities dominant in road building and road haulage and indirectly controlled by the state. Over time, their dominance has tended to increase rather than diminish, crowding-out the rest of the competition. Competition, therefore, is not only vital on the national level, but also to the functioning of cities. Pakistan’s cities, like its markets, have not yet had the opportunity to develop in an organic manner.

Pakistan is still classified as a factor-driven economy.<sup>26</sup> To revitalise competition in Pakistan, a determined and comprehensive effort is required, to simplify and rationalise, among other things,

<sup>24</sup> The paradigmatic example of this phenomenon was the collapse of the Soviet Union, which followed directly from the antipathy toward innovation and inherent informational challenges inherent to central planning.

<sup>25</sup> ‘State of Competition in Pakistan’, Competition Commission of Pakistan, Islamabad, Pakistan, 2009.

<sup>26</sup> Global Competitiveness Index (GCI) uses 140 indicators to rank countries according to twelve competitiveness pillars. The impact each pillar has on the competitiveness ranking depends on the country’s stage of development, which is decided

the duty structure on imports, the tax code, and a significant reduction in government's direct involvement in commodities markets, and its approach to procurement.

## Competitive Cities as Drivers of Growth

In Pakistan, as elsewhere in the world, cities are key drivers of growth. Idea-led entrepreneurs live in cities, and development policy must meet innovative entrepreneurs where they live. This is not to say that rural entrepreneurs are not innovative or not vitally important to Pakistan—they most emphatically are, as Pakistan remains a substantially agrarian society. However, experience over decades shows that rural entrepreneurship thrives where there are urban markets for rural output, and innovation thrives where population is dense and diverse. The most effective way to harness entrepreneurship and innovation is to improve conditions in markets generally, and in cities in particular.

For the success of cities, reform is needed in 'relational assets' and local collective goods. These include transportation, affordable housing, and other public infrastructure. But cities should also offer an environment where universities and firms have frequent face-to-face interactions and the entire range of creative capabilities in the arts, education, and the broad range of service industries are utilised for creating vibrant cities.

### Policy Proposals Related to Cities

The government should act to ensure that cities have pro-commerce zoning and building regulations. It should clearly define city limits with exclusive city ownership of its resources without splitting all cities into twin administrative areas—city and cantonment. In addition, fiscal federalism urgently needs to be adopted for promoting city growth.

The Cooperative Housing Society Act should be abolished or amended to prevent it from being used for land development for urban housing. Land acquisition law should be tightened so that it is not manipulated to develop housing, either private or public. Government ownership of land at the city centre should be reduced, in case it retards downtown development. Commerce should be given priority in city centres. Zoning needs to be based on transparent processes that involve open consultations with citizens.

Culture and education need to be included in zoning. Space is particularly needed for libraries, theatres, community centres, museums and art galleries. The government should take whatever actions are possible at the federal level to ensure that commercial activities are treated at par with industry in terms of taxation and other government policies.

The zoning paradigm must recognise and incorporate the diversity of the functions of a city rather than focusing on housing. These include:

- Modern shopping malls and densely situated retail shops
- Cold-storage facilities and warehouses
- Hotels & spaces for leisure activities (theatres, cinemas, sports events, etc.)
- A market for fresh agricultural produce in every neighbourhood
- Small stalls, kiosks and carts in every area of the city
- Offices and apartment blocks in close proximity to the shopping and business districts.

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according to the economy's reliance on factors (labour, natural resources), efficiency (product quality and production process) and innovation (ability to compete with new and unique products).



## Promoting and Creating an Innovative Society

Lack of innovative spirit in both the public sector and in the country's large private enterprises is not just a matter of insufficient resources or ill-conceived policies, but more of an unsupportive culture.

Innovation Rank				
2006-07	2007-08	2008-09	2009-10	2010-11
60	69	82	79	75

Source: State of Pakistan's Competitiveness Report 2010-2011

A crucial element of the new strategy is to increase productivity. In recent years, productivity growth in Pakistan appears to have slowed down; between 1998 to 2008 productivity accounted for only 11 per cent of growth in total GDP of Pakistan. Growth in per capita income is mostly due to gains in productivity, which come from knowledge accumulation, innovation, and improvement in efficiency and prudent risk-taking.

There is a need to understand the implications of innovation in a country like Pakistan and also examine how its surge may impact the wider economy and society. Two major regularities must be emphasised. First, the collective effect of broadly-dispersed small improvements has a significant impact on economic growth as any individual 'high-value' innovation. Second, innovations, discrete or non-discrete, involve interdependencies that spark further down-the-line improvements known as 'innovative complementarities'. These two phenomena have considerable significance for designing and devising innovation policies that would have desirable impact on development. Pakistan does not possess the required 'technological and research bedrock'. It is therefore the leveraging of differential advantages in various sectors and the adoption of foreign technologies and best practices that will lead to the development of competitive industries.

As most of the economic activity in Pakistan takes place in traditional 'non hi-tech' quarters, a policy to spread technologically-induced transformations would gradually vary the framework and the relative weight of different sectors of economy. The triple-Helix<sup>27</sup> commercialisation (of existing, newly acquired and produced knowledge) through diffusion and absorption (economy-wide) under a more benign investment climate, would pave way for establishing a truly innovative economy. Despite failures, there is a need to have an industry-university R&D alliance, targeted at high payoff areas. A number of ideas towards achieving such ends are suggested in the following pages; however, they are equally vulnerable to rent-seeking, if not implemented with caution.

### Creation and Commercialisation of New Knowledge

Government must de-couple implementation of knowledge-driven innovation based policy from the rest of its bureaucratic apparatus. It needs to form a flexible, innovation-centric, entrepreneur-lead, quasi-public autonomous body to orchestrate, implement and gauge the innovation strategy. Such a National Innovation Agency (NIA) could be guided by thinkers, innovators and corporate leaders able to form alliances with private sector, bring foreign expertise and capital, and project the

<sup>27</sup> The Triple Helix of Commercialisation includes business, university and government.



‘Opportunity Pakistan’ campaign. NIA, with private funding, could shield start-ups and pilot projects from bureaucratic, monopolistic and corporatist death-traps and should be mandated to

- a. integrate the country’s research centres with market-oriented, commercially feasible cohesive research
- b. replace the practice of producing research-for-sake-of-publication by research-for-application, and
- c. encourage business and engineering schools to commercialise research and share knowledge, endowment and facilities

University, research centres and public and private endowments should tie up to reward practical research, patent filing and publications in foreign journals. University programs must be toned-to-industry, market-driven and based on demand for skills. In addition, research papers and internships should become graduation requirements. Government might also consider supporting new and underdeveloped markets, allowing tenders from innovative companies that produce locally and make investments with constructive potential, where the government stands to be the early user—this way it could absorb some of the risks and therefore complement the demand and supply sides.

### **Diffusion and Absorption**

A national buzz about ‘Innovation’ and ‘Entrepreneurship’ should be created, where the media broadcasts and propagates success stories through TED-style<sup>28</sup> platforms, apprentice-type reality shows (to create heroes and vision for entrepreneurs and innovators, especially amongst the youth). Similarly, battle of minds, creative ideas, products, processes competitions should be sponsored in every major sector. Universities, corporations, NGOs and chambers must be collectively engaged with the process of instantly funding and mentoring best feasible ideas. Diaspora must be encouraged to liaise between their places of work and Pakistani firms enabling to tap the outsourcing potential of Pakistan. ISO certifications in best practices implementation must be incentivised while non-compliance with regulations should be penalised. NGOs must be encouraged and facilitated in social entrepreneurship at the grass-root level, to transfer expertise and knowledge to enhance productivity, efficient utilisation of resources and local employment. Finally the tax related issues confronting venture capital firms must be addressed.

### **Broader Investment Climate**

Domestic market must be liberalised along with free trade regimes and an unsubsidised economy, where sector-picking and rent-seeking does not exist. Innovation policies must be persistent in terms of a thorough legislation that curbs interference from the government. An entrepreneurial and innovation support-environment must be created through well thought-out fiscal incentives, rationalised regulations, and competitiveness regime. Effective and efficient system for licensing and intellectual property right protection must be backed by a credible, swift, judicial process. Recognition awards for companies and individuals should be given for designing and delivering novel, innovative products and processes.

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<sup>28</sup> [www.ted.com](http://www.ted.com).

## Encouraging Entrepreneurship

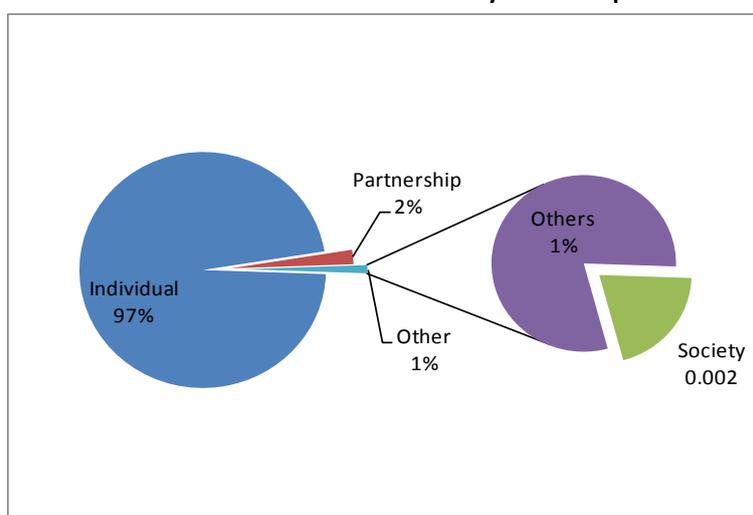
Entrepreneurs can be thought of as information processing economic agents who apply the procedures of translation and transformation to build new products and services, with a motive to profit. Economic growth is impossible without, and to a significant extent synonymous with, the creation and growth of businesses. Businesses are created and they grow when provided with needed services to introduce innovations into the marketplace. Successful firms provide revenue to the economy through wages, procurement, capital investments, returns to investors, and payment of taxes. When state and private foundations provide the infrastructure required for business creation and growth, a virtuous cycle ensues.<sup>29</sup>

### Supporting New and Rapidly Growing Companies

In case of Pakistan the firm structure is still dominated by sole proprietorship (and family run businesses). The culture of widespread IPOs is still very far. A sequence of studies has identified a consistent set of challenges that impede the growth of small firms. Foremost among these are:

- Government regulation of trade (both internally and with respect to exports) in a manner unfavourable to small firms
- Financial-sector business practices and government interventions that have failed to reach small firms
- Relative difficulty coping with high fixed costs of licensing requirements, the lack of clarity with regard to taxation, and the development of alternatives to poorly performing infrastructure (energy in particular)

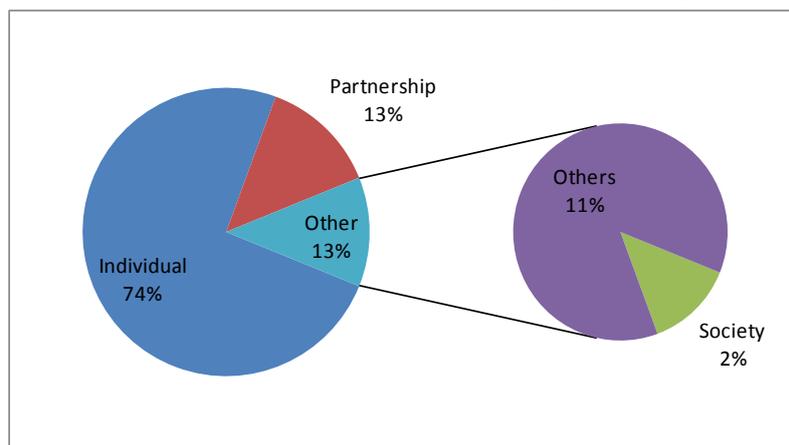
Distribution of Micro Firms<sup>30</sup> by Ownership



Source: Economic Census 2005, Federal Bureau of Statistics, Government of Pakistan

<sup>29</sup> EP Auerswald and Z Acs, 'Defining Prosperity', *The American Interest*, May-Jun, 2009, pp. 4-13.

<sup>30</sup> Micro firms are defined as those with an employment size of less than 10 employees

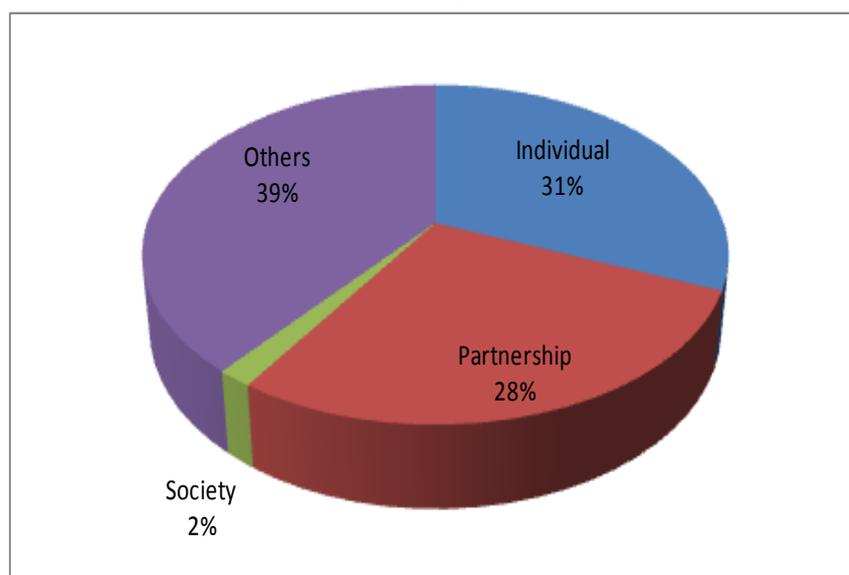
Distribution of Small-Medium Firms<sup>31</sup> by Ownership

Source: Economic Census 2005, Federal Bureau of Statistics, Government of Pakistan

Additional impediments include cultural barriers, such as social sanctions in the face of failure, lack of peer experience to enable realistic assessment of risk, a paucity of mentors and entrepreneurial role models, and inadequate understanding of markets and global business practices.<sup>32</sup> These obstacles prevent entrepreneurship and inhibit enterprise growth. Enterprises cannot scale-up beyond a certain point. Without scale, they cannot contribute fully to a country's growth, development and prosperity. It is only when an enterprise is expanding the number of jobs in a community, increasing its profits, and re-investing those profits into new products, services, methods and practices, R&D, that it contributes to per capita GDP growth. It is worth mentioning here that small firms are the first to get hit on by tax collectors wanting bribes, organised crime, and larger competitors who collude with government for their vested interests.

<sup>31</sup> \*Small-Medium Firms have 10 -199 workers. The Ministry of Industries defines this category of firms having 10-250 employees. The published data in economic census on does not provide data for this category, but the data format allowed us to extract information on firms with 10-199 employees.

<sup>32</sup> A Qayyum, I Khawaja and A Hyder, 'Growth Diagnostics in Pakistan', Working Paper 47, Pakistan Institute of Development Economics, Islamabad, Pakistan, 2008

Distribution of Medium-Large Firms<sup>33</sup> by Ownership

Source: Economic Census 2005, Federal Bureau of Statistics, Government of Pakistan

## Transitioning of Family Businesses to Business Families

Globally, a natural path of development has led from family businesses with a tradition of moral reciprocity to the modern, professionally managed corporation. Where this transition has occurred it has been based on faith in the legal and judicial system, including respect for contracts and property rights.

In Pakistan this transition has been realised slowly. Mistrust of professional managers stems not only from inadequacy of legal and judicial systems but also from the limited ability of existing institutional structures to prevent fraud, theft, and misuse of business information. This is where government can play a critical role in helping to nurture an environment of trust. In order for Pakistan's family businesses to capture national and international growth in their sectors, they must transition into businesses that are focused on growth through leadership development, succession planning, operational effectiveness, management, and transition of ownership.

Large, professionally-managed businesses, particularly in high-trust societies such as the US, Japan, and Germany, emerged due to a host of technological, financial, and market factors, but also because of an evolution in corporate management. US corporations such as Wal-Mart, DuPont, Eastman Kodak, Sears Roebuck, Tyson, Pitney-Bowes, and Kellogg etc. all started out as family businesses. Now they have become strong brands that rely heavily on professional management with current generations of founding families as shareholders with little interference in business operations.

In the absence of high trust, a society has three options for building large-scale organisations, each of which is evident in Pakistan:

<sup>33</sup> Medium-Large Firms have 200+ workers. Ministry of Industries defines this category having 250+ workers. The published data in economic census does not provide data for this category but the data format allowed us to extract information on firms with 200+ employees.

1. evolutionary growth of family businesses with only family members in decision-making positions;
2. formation and subsidisation of state-owned and state-managed enterprises; and,
3. foreign direct investment or joint ventures with large foreign partners

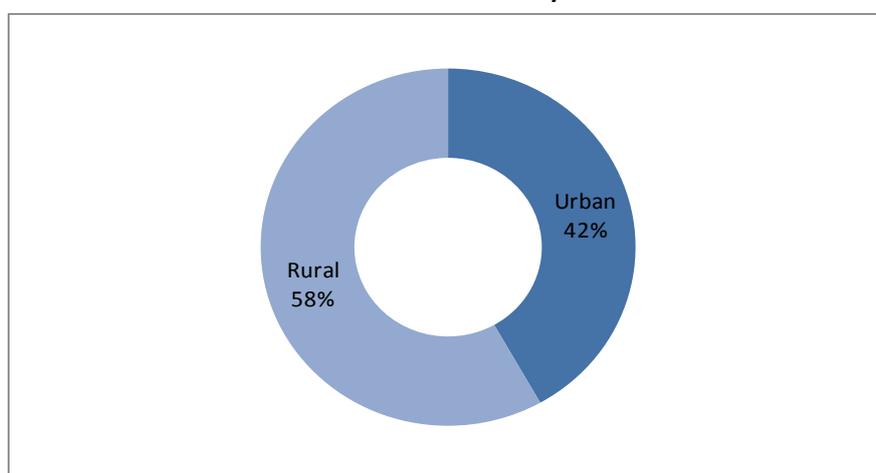
In general, the challenges faced by family businesses vary according to the size of the company and its level of development, and in Pakistan this is no different. It is encouraging that some large family owned and operated companies in Pakistan have global operations which invariably forces them to transition from family business to corporate families. They have professionalised their management, developed professional boards, diversified their ownership, and issued shares in the stock market.

Ironically, many professionally owned and managed companies seek to promote family-type values in their businesses in order to engender the commitment and trust that are hallmarks of family companies. They do this, so that the essence of family businesses and the social capital they have built are not lost. So, as family businesses decline, businesses seek to replicate the strong social ties that bind families. The real issue, then is not the preponderance of family businesses themselves, but rather how effectively family businesses manage and adapt to change. For family businesses to transition into becoming professionally managed business families, the families may continue to have a say in the vision of the business but they must also capture the creativity and entrepreneurial spirit within the spheres of their businesses through a focus on professional management driven by efficiency and growth.

### Encouraging Rural Entrepreneurship

The contribution of agriculture sector in GDP and employment underestimate the opportunity for rural entrepreneurship. Non-agricultural entrepreneurship in rural areas generates substantial income and employment. Policies and strategies to support rural entrepreneurship must therefore focus as much on non-farming communities as on small farmers.

**Distribution of Individual Owner Businesses by Urban-Rural Classification**



Source: Economic Census 2005, Federal Bureau of Statistics, Government of Pakistan

Rural entrepreneurship already contributes to increased economic opportunities, work-force development, income generation, and food security in rural areas of Pakistan, but there is still a critical need for training and assistance to both enhance the skills of small entrepreneurs and improve their connections to market opportunities—throughout Pakistan, but notably in Balochistan and KPK. The long-run solution for sustainable agricultural development is competitive agriculture.

Entrepreneurship in rural areas can benefit from public-private partnerships among governments, NGOs, universities, and the private sector to build capacity and the entrepreneurship ecosystem in rural Pakistan. A number of research universities in Pakistan are producing technologies that have significant potential to boost rural entrepreneurship. However, due to the inadequate development of the institutional infrastructure to support the transition from invention to market-ready innovation, the market potential of many of those university-generated concepts remains underdeveloped.

To realise Pakistan's potential, the nation's political and business leaders must not only meet the demands of the present, but also create a space for the future. Creating a space for the future means seeking advantage not in regulatory protections that stifle social development and encourage rent-seeking but in market innovations that accelerate growth of markets and overall economic growth, and provide a level-playing field where research and development is fruitful.

### **Creating Space for Urban Micro-Enterprises**

Urban population in Pakistan is likely to increase threefold over the next 25 years to 130 million. In 2030, urban population in Pakistan will be 50 per cent of the total population, making it among the largest urban centres in the world. The urban development in Pakistan is likely to pose new challenges in governance, development of micro-enterprises, and urban service delivery; these challenges must be addressed to allow urbanisation to fuel growth. While urbanisation does pose challenges, it will also create new opportunities for growth and prosperity. The emergence of a middle class will create a domestic market for goods and services and provide a skilled workforce that can become the engine of growth. This dividend can only be leveraged if government creates a 'formal' and 'affordable' space for urban micro-enterprise to prosper.

Supporting micro and small business is most effective where the legal and regulatory environment provides both security and opportunity while creating an effective balance between incentives and disincentives. Operating a business, including simplified registration and licensing procedures, appropriate rules and regulations, and reasonable and fair taxation, will help new entrepreneurs to get a start in the formal economy and encourage existing informal players to enter the formal sector. The security that formality provides will facilitate access to formal markets, favourable credit terms, legal protection, contract enforcement, and foreign exchange. A coherent legal and judicial framework for securing property rights and utilisation of productive capital through sale, lease or use as collateral should be a high priority.

### **Policy Proposals related to Entrepreneurship**

In terms of policy recommendations, there is a need to develop an active sensitivity to the requirements of entrepreneurs and engage them in a regular dialogue with organisations comprising entrepreneurs. Double taxation should be eliminated for companies and institutions dedicated to providing venture capital investments. Different avenues for funding high-growth ventures should be explored. City officials and academia must encourage entrepreneurs to form networks of business angels (individuals who invest directly in start-ups). Entrepreneurs should be positioned and portrayed as role models. The media should offer entrepreneurial narratives. Entrepreneurship competitions should be sponsored all over the country. A fully electronic second tier stock market (similar to NASDAQ) should be established for listing smaller firms. Similarly, support should be given



to further the development of electronic registration for businesses.<sup>34</sup> A mechanism for improved efficiency in the resolution of conflicts and disputes should be developed and implemented.

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<sup>34</sup> Klapper et al. find that in countries that have adopted an 'e-registry', the number of days necessary to incorporate a business is, on average, 21 per cent lower than in countries without an e-registry and the number of procedures is 23% lower. For details see L Klapper, R Amit. and M Guillén, 'Entrepreneurship and firm formation across countries', The World Bank Policy Research Working Paper Series 4313, Washington DC, 2008.

## Minimizing Transactions Costs

Entrepreneurship doesn't happen without deal-making in circumstances of uncertainty, which depends to a great extent on trust. While Pakistan is rich in talent and has ample capital resources (particularly when the economic assets of the Pakistani Diaspora are taken into consideration), it suffers from a significant trust deficit that not only undermines the relationship between citizens and government but also, impedes the conduct of business by increasing the cost of business transactions. Building trust takes time. Consequently the government should mitigate adverse consequences of the trust deficit by decreasing transactions costs in its dealings with citizens and increasing the transparency of government decision-making.

**Summary average amount saved by a business by adopting best practices**

Indicator	Avg. Amount saved (US \$)
Starting a business	73.28
Dealing with construction permits (better procedures)	48.84
Dealing with construction permits (better time)	845.43
Registration of property	612.85
Total	1,580.39

Source: Based on data in Doing Business in Pakistan 2010

The competitive potential of the economic structure is determined not only by the nature of competition in core industries and the latitude that exists for entrepreneurial entry. Underlying both entrepreneurship and competition is the need for trust. Fukuyama has observed that there are other factors accounting for firm size, including tax policy, antitrust, and other forms of regulatory law. Hence, there is a relationship between high-trust societies with plentiful social capital and the ability to create large, private business organisations. These societies were the first—both on an absolute time scale and relative to their own development histories—to develop large, modern, professionally managed hierarchical corporations. However, in [low-trust] societies the reluctance of non-kin to trust one another delayed, and in some cases prevented the emergence of modern, professionally managed corporations.<sup>35</sup>

If a low-trust society wants to have large-scale businesses, the state must step in to help create them through subsidies, guidance, or even outright ownership. The result will be a saddle-shaped distribution of enterprises, with a large number of relatively small family firms at one end of the scale, a small number of large state-owned enterprises at the other, with relatively little in between.<sup>36</sup>

Fukuyama's analysis indicates the low level of trust in Pakistan is as much the cause as it is the result of economic stasis. Government actions and incentives that favour powerful incumbents undermine trust within the society but such interventions may themselves be induced by low levels of trust within the society. Low levels of trust translate into the high costs of business transactions.

A key element of the New Growth Framework, then, is to implement strategies that minimise transactions costs and build trust by focusing on the interaction between the government and the citizens of Pakistan along three dimensions:

<sup>35</sup> F Fukuyama, 'Trust: The Social Virtues and The Creation of Prosperity', Free Press, 1995.

<sup>36</sup> Ibid.



1. Information—Timely, consistent, and easily accessible information is critical to building trust. Where citizens can access information about laws and government processes—including hours of operation and the documentation required to complete a process—trust increases. Where the media provides accurate reporting with verified sources, trust is increased. The Pakistani government has put some of its processes online. The 2008 Securities and Exchange Commission’s e-Services are an example. E-Services have enabled online company registration, which has resulted in an increase in the number of companies registered in Pakistan.
2. Transparency—The ease with which citizens can access information is as critical as the accuracy of the information itself. Trust is increased whenever a citizen can easily identify operative laws, rules, and procedures, and otherwise access information vital to business and personal functioning in society.
3. Connections—Networks are well known to be critical to an entrepreneur’s success. People trust one another when they interact with and know one another. Bringing people together is another way to enhance trust. Societies in which officials seek votes, reach out to the community, and hold town hall meetings have an increased level of trust. The government can increase the connectivity of the society by making the most of its potential role as a neutral convener.

The state of industry cluster development was ranked relatively high by the Global Competitiveness Report—Pakistan ranks 43<sup>rd</sup> out of 139 countries. This is due in part to conscious industry-cluster development strategies implemented in recent years by the pioneering private-public partnerships in sectors such as dairy, gems and jewellery, marble and granite, horticulture, leather, sports goods, and other areas. The innovative programs implemented by SMEDA have brought industry clusters together and provided support for implementing strategic initiatives designed to improve the competitive position of these Pakistani industries in the global markets. Pursuing an intelligent strategy, the Government of Pakistan has not tried to create clusters or pick winners and losers, but has sought to expand cluster development organically and strengthen the value chain linkages within existing industries.<sup>37</sup>

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<sup>37</sup> ‘The State of Pakistan’s Competitiveness Report 2010-2011, Recovery and Rebuilding the Foundations of Pakistan’s Competitiveness’, Competitive Support Fund, Ministry of Finance, Government of Pakistan, 2010.



## Transitioning to an Entrepreneurial Economy

Over the years, a variety of policies were used for planning accelerated economic growth, but almost all of them amounted to a subsidy to industry. Infant industry argument is still used for protecting industry. Licensing, concessional financing schemes, and other subsidy regimes were offered but they did not develop entrepreneurship. Incentives of the type that are offered in Pakistan cannot develop entrepreneurship on the Schumpeter-Knight-Drucker model. The incentive regime has created more of a rent-seeking businessman used to manipulating policies for vested interests.<sup>38</sup> As a result, entrepreneurship is stifled, while rent-seeking has become the main form of business. Businessmen rather than entrepreneurs acquire wealth and learn ways to manipulate the government in their favour.<sup>39</sup>

These policies have contributed to slow growth in indigenous enterprises. Wealth has remained concentrated in the hands of those that the government favours. Consequently, even in private enterprises, merit has given way to government discretion. An interesting ramification of this industry-focused mercantilist approach is the neglect of the service sector and domestic commerce. Service sector, which is the largest employer in the country, is not regarded as contributing to growth and production. Many domestic commercial activities are severely constrained because of the government favours bestowed on industrial production. City regulation offers space mostly to accommodate housing—that too for the very rich; small shops; government offices in city centres. There is little or no room for entertainment, hotels, and shopping malls, even for commercial needs such as offices, warehouses, storage and wholesale activities. As a consequence, the growth of construction, warehousing, hospitality, entertainment and retail has been stunted and stifled.<sup>40</sup>

Some of the analyses and proposed initiatives in this report have been recommended in the past also. This prompts one to question the validity of the new round of initiatives to enable economic growth—a new approach—and their success where previous efforts have not. There are at least four reasons for this:

1. Previous initiatives to support entrepreneurs were sporadic and inconsistent with other aspects of economic policy. The opportunity exists today for the government to deploy a coherent and consistent entrepreneurship-led growth strategy.
2. Competitive and demographic challenges facing Pakistan have only intensified in the past two decades, requiring urgent support for innovation and entrepreneurship. Hence, the likelihood that parties that otherwise would be opposed to market reform might align in favour of policies to support entrepreneurs.
3. Perhaps most significantly, the dramatic diffusion of information and communications technologies and other distributed technologies has created new pathways to address longstanding disadvantages to entrepreneurship and innovation.

<sup>38</sup> Since there was no bankruptcy law, the government essentially took over industries that ran into difficulty under the rubric of 'sick industries'.

<sup>39</sup> Costs of business surveys have been pointing to the amount of time and resources that business is using to interface with government.

<sup>40</sup> For more on this important theme of neglected domestic commerce and stifled city development, see NU Haque and SI Waqar, 'Domestic Commerce – The Missing Link', Trade Initiatives from a Human Development Perspective, Planning Commission, Government of Pakistan, 2006.

4. Innovation has been severely limited because the planning system has been unable to understand it. The planning model developed in Pakistan since independence encourages government interventions on the assumption that markets fail. Innovation requires entrepreneurs to take well calculated risks and commercial innovation. The nationalisation period in Pakistan affected innovation quite adversely and in subsequent years very little of it could take place. As a result, the entire essence and the spirit of innovation were strangled.<sup>41</sup>

Accomplishing the transition to an entrepreneurial and innovative economy will require directly addressing fundamental and longstanding issues, but at the same time it will require making the most of particular opportunities inherent in the historical moment. This section focuses on four such opportunities:

1. Acting assertively to capture the ‘demographic dividend’
2. Engaging Diaspora talents and resources
3. Countering the Lack of Research, Expert Skills and Knowledge
4. Accelerating the Mobile Revolution

### Acting Assertively to Capture the “Demographic Dividend”

Pakistan’s population has tripled in less than fifty years, and it will increase by an additional 85 million by 2030. Pakistan's population is currently growing at an annual rate of about 1.7 per cent. The age structure of the population and the rate of its participation in the labour force have made the latter increase at about 3.2 per cent a year, and suggests that it will rise to about 3.5 per cent a year in the next five years. To meet the needs of its growing population, Pakistan’s economy must grow by 7 per cent each year; that means it must add 36 million new jobs in the next ten years.

The education and social systems do not encourage or facilitate entrepreneurship as a preferred career option among the youth. High-growth, opportunity entrepreneurship is excessively restricted to those belonging to existing business families or by students at premier business schools. As a result, the economy witnesses too few new enterprises being created; those that are created are disproportionately skewed towards traditional areas of business, creating congestion in a few markets while other markets remain untapped.

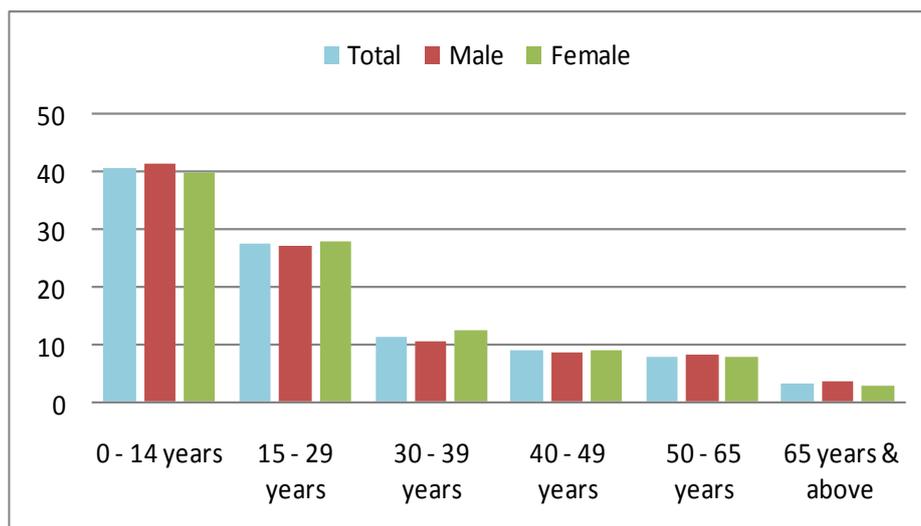
**Economic Classification of Labour Force by Age**



Source: Economic Survey of Pakistan 2008-09, Government of Pakistan

<sup>41</sup> NU Haque, ‘Entrepreneurship in Pakistan’, Working Paper 2007:29. Pakistan Institute of Development Economics, 2007

Distribution of Population in Pakistan



Source: PSLM 2008-09, Federal Bureau of Statistics

Between 1972 and 2010, Pakistan's GDP is estimated to have grown at an average rate of 5 per cent a year. But to become a middle income country, Pakistan needs to grow at 8 per cent per year, on a sustained basis, for about 20 years. With the proper institutional context in place, experience elsewhere (as well as from the Pakistani Diaspora) suggests that the entrepreneurial capabilities of the Pakistani people remain a significant and untapped resource for development. If this potential can be unleashed by providing a level playing field, information, awareness, and support in establishing enterprises, Pakistan can witness fast-paced growth as new enterprises create new employment opportunities, thereby improving the distribution of wealth and exploiting the opportunities offered by international markets.

There is a need to promote entrepreneurship actively by:

- a. implementing curricular enhancements pertaining to entrepreneurship (for example, modelled after Jordan's successful Injaz al-Arab program),
- b. creating awareness among youth, and, more importantly,
- c. providing effective support mechanisms, including access to capital, mentoring, and skill-building, to those who want to establish new enterprises. The ultimate objective of entrepreneurship education policies should be to facilitate the creation of an entrepreneurial culture, which in turn will help potential entrepreneurs to identify and pursue opportunities. Government policies on entrepreneurship education are critical to ensure that entrepreneurship is embedded in the formal education system and offered through partnerships with the private sector, with the informal community, and with apprentice-training programs in rural areas.<sup>42</sup>

<sup>42</sup> C Volkmann, KE Wilson, S Mariotti, D Rabuzzi, S Vyakarnam, and A Sepulveda, 'Educating the Next Wave of Entrepreneurs: Unlocking entrepreneurial capabilities to meet the global challenges of the 21st Century', World Economic Forum (Global Education Initiative), Geneva, Switzerland, 2010

The age-distribution of the population provides a strong imperative for acting quickly. Nearly 50 per cent of Pakistan's population is below 20 years of age, and over 60 per cent below 30 years. With growing unemployment, youth become disconnected from the country's economy and disaffected with its political structure, and are vulnerable to the blandishments of extremists.

Pakistan currently is experiencing an unprecedented 'demographic dividend' as the working-age population bulges and the dependency ratio declines. This shift is as much an opportunity as it is a challenge. The demographic dividend available to Pakistan and its implications for the country mainly reflect three key issues of labour supply, savings and human capital. For economic benefits to materialise there is a need for policies dealing with education, public health, and those that promote labour market flexibility and provide incentives for investment and savings. In contrast, if appropriate policies are not formulated, the demographic dividend could lead to mass unemployment and put an unbearable strain on education, health, and old-age security and political instability.<sup>43</sup>

If young Pakistanis can be properly educated and successfully absorbed into the labour force, the country's demographic dividend could boost social well-being, spark economic growth and prevent social and political unrest.<sup>44</sup>

## Engaging Diaspora Talents and Resources

The Pakistani Diaspora community could be an invaluable resource for the national development of Pakistan. Their contributions to economic development could be substantial through platforms of knowledge economy and via knowledge networks if leveraged strategically and diligently. The Pakistani Diaspora is significant, numbering roughly ten million people around the world. Formal remittances to Pakistan were USD 8 billion in 2008. This was nearly same level as foreign direct investment, which was only USD 500 million per year in the 1990s—an increase by a factor of 16 for Pakistan, compared to an increase factor of 10 for emerging markets as a whole.<sup>45</sup>

Demographic projections show this 'youth bulge' continuing to dominate the population for another 30–35 years. Unless Pakistan can sustain a high level of growth of its GDP, its streets are likely to be crowded with millions of young people desperately seeking jobs, justice, education, and medical attention for themselves and their families. The 'brain gain' from this group could indirectly improve overall governance in aspects of social, economic, and political life by further activating the entrepreneurial space. Examples of this include a memorandum of understanding signed between Lahore University of Management Sciences (LUMS) and the Organisation of Pakistani Entrepreneurs (OPEN) for cooperation to establish the OPEN Centre at LUMS for Innovation and Entrepreneurship on July 29, 2010, for a period of five years. The centre aims to create an entrepreneurship network that sustains entrepreneurs and promotes the creation of new ventures to foster economic growth in Pakistan. Similarly, the Indus Entrepreneurs (TIE) has three chapters in Pakistan located in Karachi, Lahore, and Islamabad. It provides a platform for business plan competitions, networking forums, start-ups, mentorship, entrepreneurial summits, and much more. All these local chapters are operated by well-known Pakistani entrepreneurs.

<sup>43</sup> D Nayab, 'Demographic Dividend or Demographic Threat in Pakistan?', *The Pakistan Development Review*, Pakistan Institute of Development Economics, Islamabad, vol. 47, no. 1, 2008, pp.1-26.

<sup>44</sup> DE Bloom and RB Freeman, 'Population Growth, Labour Supply, and Employment in Developing Countries', NBER Working Papers 1837, National Bureau of Economic Research, 1986.

<sup>45</sup> The Legatum Prosperity Index, 2010.

Done on a larger scale, this could also pave the way for direct links between entrepreneurs in Pakistan, and entrepreneurs of Pakistani origin that would enable them to invest in high-impact entrepreneurial ventures. The Pakistani government should seek to encourage such exchanges by improving the business environment and offering incentives, as has been demonstrated successfully in South Korea, India, and China. Pakistan represents a growth market for mobile communications and applications that can provide significant impetus for the development of an enterprise economy.

There are signs that Diaspora entrepreneurship of this kind might be growing, albeit in different shapes and forms. The key Diaspora-driven entrepreneurship showcases a safer way to enter a new market like Pakistan and minimises risks for foreign companies seeking to operate there. It ties a lot of reputation and network capital of these Diaspora founders to the venture capital of US investors, thus considerably enhancing the chances of success. One model of Diaspora entrepreneurship is the 'straddling expatriate' who lives in the United States or Europe (the developed markets) but operates a company whose development hub is in a developing country—in this case, Pakistan. The second model of Diaspora entrepreneurship is the 'returning expatriate' who, after spending several years abroad, has now returned to his native country—at least partially—and helps to develop a foundation for innovation and employment in his native country.

### Countering the Lack of Research, Expert Skills and Knowledge

Business in Pakistan remains largely owner-operated and resistant to developing professional management. This is partly because business has depended on policy favours rather than on professional management and strategy. There is also a clear mistrust of professional managers because the legal and judicial systems are not able to swiftly adjudicate fraud, theft and outright misuse of business information and are often engaged in bribery.

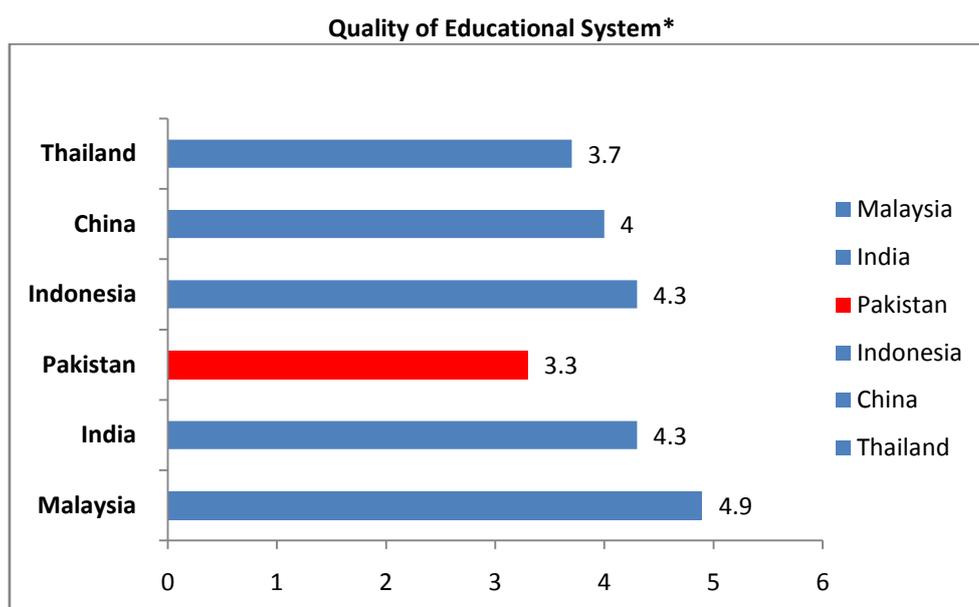
Enterprise owners are beginning to understand the demands of globalised business growth. They realise and admit that an important reason for slow growth as well as developing a new business is the lack of expertise and knowledge—they feel there is no expertise for providing advice on project feasibility, operating a business, establishing brand names, and marketing.<sup>46</sup>

Hoening emphasises an educational system that develops the skills of entrepreneurs and workers to foster an entrepreneurial economy.<sup>47</sup> While some management schools have emerged, technical and skill-based professional education remains in short supply. Trade bodies and chambers ask the government to make an investment in this area but do not wish to incur the cost themselves. In most instances, professional and technical skills are not adequately rewarded by employers; nor are professional jobs held in esteem in the Pakistani society.

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<sup>46</sup> Even when bank financing requires a feasibility, investors tend to copy some else's outdated feasibility.

<sup>47</sup> TH Hoening, 'Entrepreneurship and Growth', *Entrepreneurs' Experiences: A Town Hall Meeting, Entrepreneur's Exchange*, Kansas City, Missouri, 2005



Source: Global Competitiveness Report 2010-2011

\* [1 = not well at all; 7 = very well]

Knowledge spill over remains narrow and imitative, due to lack of market depth; research institutions; universities; and, other knowledge producing entities. The experience of the developed countries indicates that research is undertaken by specialised research institutes / universities and then the knowledge produced by them is commercialised by private firms.<sup>48</sup>

## Accelerating the Mobile Revolution

Pakistan represents a growth market for mobile communications and applications that can provide significant impetus for the development of an enterprise economy. The widespread use of mobile phones creates a particular opportunity in the financial services industry to increase competition and thus extend financial inclusion through branchless banking. Through the Branchless Banking regulation issued by the State Bank of Pakistan in March 2008 and the Branchless Banking guidelines issued by the Pakistan Telecom Authority in June 2008, the government has provided a platform for widespread deployment of branchless banking services. However, for reasons outlined at the outset—excessive monopoly rents derived from core lines of business—as well as the fragmented (and highly competitive) nature of the Pakistani mobile phone industry, branchless banking services have been slow to develop in Pakistan. To date, only one consumer offering exists—Telenor’s ‘easypaisa’—that service has limited functionality and reach when compared to mobile-enabled branchless banking services elsewhere in the world. Accelerating the deployment of branchless banking could be a key driver of competition in the financial services industry, and potentially also a facilitator of entrepreneurship in Pakistan.<sup>49</sup>

The Government of Pakistan can act in other ways to accelerate the beneficial impact of the mobile revolution, potentially including:

- Accelerating the adoption of leading mobile services, such as mobile payments

<sup>48</sup> Lack of a research and innovation culture constrains Pakistan even in the policy space (See NU Haque 2007)

<sup>49</sup> See CGAP (Consultative Group to Address the Poor), 2010

- Developing shared standards for data exchange, facilitating interoperability (via ‘cloud computing’)
- Encouraging flexible regulation that does not impede innovations that could transform delivery of essential products and services to the poor
- Easing the process by which remittances can be transferred via mobile phones
- Actively supporting the development and deployment of open-source, interoperable mobile applications (in particular SMS) in a range of areas, including health and financial services, through direct funding, prizes, and the facilitation of advance-usage commitments
- Nurturing entrepreneurship in the development of mobile applications among youth with programming skills

## Supporting the Deployment of Distributed Energy Technologies

Two-way metering, dynamic pricing and other market-based policy initiatives can open the door to market entry by a variety of new ventures in electric power generation and transmission. Distributed solar-, wind-, and hydro-power are all well adapted to different parts of Pakistan. With the right government policies in place to support their exploitation, each has the potential to positively complement the electric power industry in Pakistan—which today is dependent on oil, an inefficient and volatile energy source for electric power generation.

Hydroelectric generation is one of the oldest forms of electricity production, but in the 20<sup>th</sup> century, hydroelectric development focuses on an ever-increasing generation capacity. Large, capital-intensive hydro efforts, such as the Hoover Dam and Tennessee Valley Authority in the US, have led to similar projects throughout the world, such as the Aswan Dam in Egypt. More recently, research and entrepreneurial activity have spurred renewed interest in smaller hydroelectric generation facilities, especially for international development. The term ‘micro-hydro’ commonly refers to facilities with generation capacities generally less than 100 kW, which do not significantly alter local environmental conditions or river flows.<sup>50</sup> A relatively new subset of micro-hydro is pico-hydro, which includes very small systems that generate less than 5 kW of capacity. These concepts are especially relevant for communities in rural and developing areas as a way to generate cost-effective, low-impact electricity.<sup>51</sup>

Pakistan is ideally situated geographically for implementing micro-hydro facilities. Micro-hydro generates electricity by diverting upstream river water through a side chute to a set of turbines downstream. Micro-hydro facilities operate in ‘low-head’ environments, where the difference between the upstream intake and downstream outlet is at least 30 metres. Depending on energy usage, infrastructure, and geographical distribution, a micro-hydro facility can provide electricity for about 100 households. Chattha, Khan and Haque<sup>52</sup> estimated the total potential hydro resources of Pakistan to be 41 GW, with 1290 MW suited to micro-hydro development. They estimate that the ‘off grid micro-hydro systems are very essential for the consumers living in the remote areas of Pakistan and may be installed on canals and waterfalls which are abundant in the remote areas’. Development programs in Pakistan and neighbouring Afghanistan have broadened rural access to electricity through innovative micro-hydro systems. They have not only built the facilities, but also developed the community-based governance mechanisms that regulate output and pricing.<sup>53</sup>

<sup>50</sup> JR Moriera and AD Poole, ‘Hydropower and its constraints’ in Johansson, *Renewable Energy*, Chapter 2, 1993, pp.13-119

<sup>51</sup> See The Ashden Awards for Sustainable Energy 2010, University of Nottingham

<sup>52</sup> JA Chattha, MS Khan, and AU Haque, ‘Micro-Hydro Power Systems: Current Status and Future Research in Pakistan’, in ASME 2009 Power Conference, 2009, pp.629-636

<sup>53</sup> See ‘Afghan Villages Bolstered by Micro-Hydro Power Plant’, Development Alternatives Inc, 2010, and ‘Solar Power for Communities, Farmers and Market Traders across India’, Aga Khan Rural Support Program, 2004

Given the favourable geographical characteristics in Pakistan for micro-hydro, an equally favourable environment for entrepreneurship could induce the development of a regional entrepreneurial cluster related to micro-hydro installation. Novel micro-hydro designs could also integrate other services needed by rural populations, such as drinking-water filtration, making Pakistan an entrepreneurial laboratory within the hydroelectricity sector. To enable the entry of new firms into distributed solar-, wind-, and hydro-power generation and transmission, the Government of Pakistan should fully implement two-way metering and dynamic pricing in energy markets. It should also institute lower-bounds for regulatory oversight in energy markets and lower barriers to meso-scale energy generation.

### **Strategies for National Transformation – Turkish Example**

By 1980, Turkey's state-planned economy had come to a halt. Inflation was in the triple digits, unemployment was rampant, and debt was through the roof. Turgut Ozal, a World Bank economist, took the reins of power and made radical changes that led to Turkey's development and enabled entrepreneurial growth. They are seen as radical, which they were, but they were also simple. Ozal's reforms were intended to bring legal order to what was being done on the black market. He didn't have a grand scheme for turning the country into a second Sweden; he instead changed the rules so that everyone would have the incentive to participate in the formal economy.

Ozal's signature reform was redirecting government support to those (businesses) that could export and generate badly needed foreign reserves. Tariff rules, exchange rates, and subsidies were all changed to promote exports. Among those who thrived especially well were makers of textiles and furniture, which were clustered mostly in industrial zones in the Anatolian heartland, far from Istanbul. By 1990, Turkish designers and engineers had started to create their own products rather than simply filling orders for foreign firms. Others started investing in factories and franchises in various communities. In addition, Ozal made it a priority to allow capital to move freely in and out of the country. One way he did that was to bring into circulation unused capital from those opposed to interest-bearing banking. He also developed economic ties with wealthy Gulf States and encouraged them to invest in Turkey.

Ozal visited countries to see what was new in stores and shopping malls. He worked to communicate his consumer hunger to his people. He made it a priority to bolster Turkey's statistics office. He made statistics available on a large scale. The resulting transparency and access boosted public confidence.

In terms of trade, Ozal lifted quotes on imports. He believed that the sight of fancy foreign goods on previously monotonous shop shelves would encourage the Turkish people to work harder to earn more money to buy them. The biggest change Ozal made was to shift resources from supporting state industries to infrastructure projects. He spent huge amounts on new motorways, bridges, dams, and airports. He was famous for his BOT (Build, Operate and Transfer) effort, which called on foreign companies to undertake infrastructure projects at their own expense, turn a profit, and then hand over operation to the Turkish state.



## Improving Governance & the Legal Framework

The most important measures the government undertakes fall under the domain of better 'governance'. These for example, would require addressing the workings of bureaucracy, commercial judicial system, taxation system, regulatory framework, price mechanism, institutional arrangements for education and health, and so on.

Rule of law is a basic institution which businesses rely on. Unfortunately, in Pakistan, no one seems to be sure of the rules in which they are operating. Rules such as property rights, zoning, and licenses are often changed for individuals on the basis of their clout. In that sense one is never sure of the market environment one is operating in. There is no faith in the legal system to enforce even the basics of business—property rights and contracts. For example, businessmen prefer to use self-owned facilities rather than renting premises because of poor contract enforcement. When a business gets established, the landlord may demand either a significant increase in rent or demand that the place be vacated. When the premise is vacated, it is rented to a competitor of the previous incumbent or at times the owner himself commences the same business at the same place. However, in developed countries the landlord is not allowed to use the premises for similar kind of a business for a certain length of time.

**Enforcing Contracts in Pakistan**

Enforcing Contracts Data	Doing Business 2011
Rank	155
Procedures (number)	47
Time (days)	976
Cost (%age of claim)	23.8

Source: Doing Business Report 2011

Labour trained by one employer either moves to another employer or opens up his own firm. Contracts written to protect employers as well as employees are not enforceable and allow gains to be captured by parties that do not invest in organisation capital. Poor contracting arrangements also prevent incentive mechanisms that benefit employers and employees, such as stock options and bonuses.

The New Growth Strategy actually goes further. It aims to harness the community's entrepreneurial energy by, making markets more flexible and easier for cities to act as generators of growth. These measures are especially important because they would spread the fruits of growth more widely and help to reduce poverty and geographical inequalities. In addition, it pays considerable attention to matters of economic governance, that is, to the formulation and implementation of rational, efficient, and equitable rules and procedures for the management of economic assets and activities.

Pakistan's economic history is one of high volatility in growth rates. This 'stop-go' growth was a feature of Pakistan's history since the 1950s to the present day regardless of the party in power or whether the Government was in the hands of military or civilian rulers. The uneven economic performance was neither caused by global market conditions nor by the policies of other nations or international financial institutions, but by Pakistan's economic policies. Policy instability was in many cases a matter of institutional instability. Prominent Pakistani economists have argued that unstable growth and endemic poverty in Pakistan is partly a result of institutions that favour the status quo and restrict merit-based selection, competition, efficiency and innovation. In recent years,

disillusionment amongst some population groups in under-developed regions may have contributed to militancy and unrest, which has compromised the sense of loyalty and identity with Pakistan as a nation. Good institutions, on the other hand, foster a sense of belonging to the nation. Institutional constraints to competitiveness include the inadequate provision of security, ineffective public utilities, red tape, weak property rights, inadequate contract enforcement, perceived lack of transparency, and inadequate corporate governance.

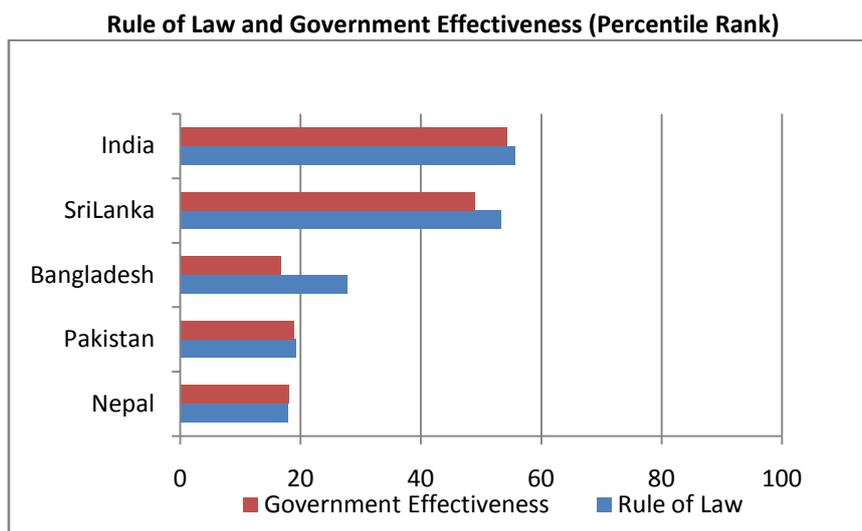
Weak institutions have hurt Pakistan's economic performance by restricting the nation's ability to make the necessary structural transformations for the future and preventing fair distribution of the benefits of growth to disadvantaged groups. Specifically, weak property rights hinder the mobilisation of investment and its productivity. Formal property rights and their effective enforcement encourage investment by securing the owners against expropriation and providing access to credit markets. They also help promote the efficient functioning of land markets and productive use of land. Furthermore, property rights encourage formal registration of business as well as personal property, bringing assets into the formal sector and thus contributing to a broader base of tax-payments.

In the 21<sup>st</sup> century knowledge economy, intellectual property rights are becoming as important as property rights in land. Insufficient intellectual property rights protection may be a contributing factor to Pakistan's relatively poor performance in the export of IT-enabled services and in knowledge-based products and services. Pakistan has not been notably successful in establishing global brand names or in attracting international investment in R&D within Pakistan's borders. Security of other property such as money, financial assets or physical assets other than land is captured in the other institutional constraints to competitiveness.

In the 2010–11 Global Competitive Index (GCI) ranking, Pakistan ranks 107<sup>th</sup> out of 139 economies in protecting property rights. This is far below that of India (61), Sri Lanka (64), Brazil (72) and Thailand (89). Pakistan's performance in the property rights sub-indicator is mirrored in the World Bank Doing Business report where it ranks at 119<sup>th</sup> out of 183 for the indicator of registering property.<sup>54</sup> There is clearly room for improvement, which is entirely under the control of the Government. According to the World Bank study, it takes 6 procedures, 50 days and an average cost of 7.2 per cent of property value to register property in Pakistan. Illegal possession, informal occupation and disputed titling remain major hurdles in creating efficient and well-functioning land markets. Registration and land record management remain disaggregated, as multiple institutions are involved. Land record systems are old and obsolete. At the most basic and local level of land registrations, the *patwaris* (land record keepers and administrators) are vulnerable to political influence and exploitation. Meanwhile, land markets remain thin, and land prices do not reflect the true productive capacity of the land. Higher land values based on more secure titles could trigger access to credit that could in turn lead to expanded economic activity.

Current legal, regulatory and administrative frameworks governing private sector activity are inefficient and they unnecessarily raise the cost of doing business. Properly functioning and transparent legal, regulatory, and administrative frameworks encourage investment and create an enabling business environment. Pakistan lags behind other comparator countries in modernising various commercial laws that govern private sector activity. This is evident from Pakistan's low ranking on the GCI sub-indicator for efficiency of legal framework in settling disputes and efficiency of legal framework in challenging regulations.

<sup>54</sup> 'World Bank, Doing Business 2010 Pakistan', World Bank, Washington DC, August 2009



Source: World Bank governance Indicators

Better contract enforcement would improve productivity and encourage investment. Timely and affordable contract enforcement is essential for the smooth functioning of markets. Problems associated with contract enforcement not only inhibit investments, but also discourage scaling up and retard productivity. Pakistan not only lacks the appropriate legal frameworks for settling disputes efficiently as discussed above, but it also performs poorly in enforcing existing laws. According to the World Bank’s Doing Business Report in Pakistan, 47 procedures have to be followed for the ‘enforcement of contracts’. It takes on average 976 days to reach a settlement, with an enforcement cost of 23.8 per cent of the total value of the contract.



## Conclusion

Conventional wisdom holds that a country can transition from a 20<sup>th</sup> century industrial economy to a 21<sup>st</sup> century entrepreneurial economy only after its political institutions have fully matured. Read backwards, it means that a country's political institutions mature only as its economy produces broad-based opportunities on a sustainable basis. Similarly, internal security and political stability are not prerequisites for, but the consequence of, broad-based social development that is driven by competition and entrepreneurship and supported by increasing levels of social trust. Actions taken in the name of near-term stability that undermine competition and economic dynamism not only make a country less prosperous—they also make it less secure and less stable.

In Pakistan, the real cost of excessive preoccupation with the hardware of economic growth is that it draws attention and resources away from the software of economic growth—namely, efficient organization and management of assets. Indeed, crises of any type have the same effect—they divert resources from the future and towards the present.

Contrary to international perception, Pakistan is no more a violent or dangerous place than many other countries in the vicinity. India (Naxalite rebels, Hindu extremists), Sri Lanka (Tamil Tigers), and Turkey (Kurdish nationalists) are all places where indigenous and imported terrorists have been active. However, this has not prevented those countries from developing rapidly. Taking the comparison farther ahead, gang and politically related deaths in Mexico during the past three years have been nearly four times than in Pakistan. The difference is that Pakistan's security challenges have an international profile, and thus they attract greater attention than would otherwise be the case. As a consequence of diverse pressures, demands of the present have been so great for the past twenty years in Pakistan that the future has persistently been put on hold. There will be new exigencies of the moment. The impetus will be great to revert to familiar modes of argumentation and action—crisis, assistance, projects. What is needed, however, is a decisive break with the past: a new approach that creates new modes of argumentation and action—competition, entrepreneurship, and trust.



<b>Policy Action Matrix</b>				
<b>Themes</b>	<b>Short Term (1 Year or less)</b>	<b>Medium Term (3 to 5 Years)</b>	<b>Long Term (More than 5 Years)</b>	<b>Institutional Involvement</b>
Eliminate government policies, programmes and projects that crowd out private business initiatives and create perverse incentives				CCP, SECP, State Bank of Pakistan, Ministry of Finance, Planning Commission, Provincial P & D Departments
Phase out distortive subsidies and protections particularly in the industrial sector				CCP, SECP, SBP, Ministry of Industries, Ministry of Finance
Institutionalise bankruptcy laws consistent with international norms				CCP, SECP, Ministry of Commerce, Ministry of Industries, EDB, BOI, FBR, SBP, Ministry of Law
Rationalise regulatory framework for non-bank financial institutions				CCP, SECP, Ministry of Commerce, Ministry of Industries, EDB, FBR
Revisit tax laws that hinder investment particularly with respect to venture capital firms				Ministry of Finance, FBR, Provincial Finance Departments
Deregulate agricultural markets and improve storage and warehousing facilities				Provincial Agriculture and Finance Departments, Ministry of Law, Ministry of Finance, SBP
For stimulating domestic commerce, define and decentralise city limits and give municipalities ownership to their land and resources				Municipal Authorities, Provincial Governments, Federal Bureau of Statistics, NADRA
Abolish Cooperative Housing Society Act				Ministry of Law, Justice and Human Rights
Allow development of city centres for dense mixed-use				Provincial Governments, Municipal Authorities
Strengthen enforcement of land titles, acquisition, settlement and related laws				Ministry of Law, Justice and Human Rights, Provincial governments, Municipal Authorities
Encourage entrepreneurs to form networks of business angels				SECP, CCP, FBR, Chambers of Commerce, Pakistan Business Council, Higher Education Commission
Establish an electronic second tier stock market (similar to NASDAQ) for listing smaller firms				SECP, CCP, FBR, Financial Institutions, SBP, Chambers of Commerce, Karachi Stock Exchange



Strengthen enforcement of intellectual property and related rights				Intellectual Property Organization, FBR, Engineering Development Board
Provide effective support mechanisms, including mentoring, and skill-building, to those who want to establish innovative ventures in a community setting				Microfinance institutions, Ministry of Industries, Ministry of Commerce
Accelerate adoption of cellular services for banking and non-banking services				Ministry of Law; Ministry of IT, SBP, NADRA
Develop shared standards for data exchange, facilitating interoperability (via 'cloud computing')				Ministry of Law; Ministry of IT, NADRA
Supporting development and deployment of open-source, interoperable mobile applications (in particular SMS) in a range of areas, including social services such as health				Ministry of Law; Ministry of IT, NADRA, Provincial Governments



## Annexure 1

### How Entrepreneurship Impacts Economic Development

Decades of quantitative, macro-level studies of development offer little, if any, evidence to support the claim that official development assistance—foreign aid—can accelerate development on a national scale. If anything, historical evidence suggests that aid has a corrosive effect on governance and distorts the evolution of markets. Countries heavily dependent on development assistance characteristically suffer from an ‘aid curse’ that is functionally comparable to the ‘resource curse’, which is known to undermine the development of countries dependent on revenues from natural resources. In both settings, a similar irony is at work: greater revenue and diminished accountability to citizens in the short-term lead to slower development in the long term.

#### Fundamentals

To be sure, the realities of research in development economics are such that even the most able scholars have difficulty establishing proof that any approach to accelerating development has been ‘successful’ in one place or another. Yet while academics and policy-makers are still searching for the best approaches to accelerate development, the process of development itself is actually fairly well understood. Ample historical evidence supports the following general assertions about the manner in which development occurs:

- Development is an ongoing process of social change—subject to regular disruption—that involves institutions, culture, and technology.
- While societies can advance for a short while through incremental adjustments to the status quo, long-term development requires entrepreneurship and innovation.
- Entrepreneurs and innovators exist in all societies, but not all societies are equally welcoming of the disruptive changes they provoke.
- Individual entrepreneurs and innovators thus face three options: seek economic rents within the status quo; challenge the status quo through disruptive innovation; leave the society altogether to seek an environment more welcoming of creativity.<sup>55</sup>
- When too large a fraction of potential innovators and entrepreneurs choose either to seek rents within the context of the status quo or to leave the society altogether, development slows or comes to a halt.

This implies that creating a place for the future in any country means creating a space for entrepreneurship and innovation—and, in particular, encouraging the subset of potential entrepreneurs and innovators who choose neither to conform nor to depart, but rather to stay and build something new. Entrepreneurship is present in all societies but manifests itself differently depending on the context.<sup>56 57</sup> While there is little evidence that government action can affect the

<sup>55</sup> These three options (taken in reverse order) are analogous to the fundamental political options articulated by Albert Hirschman (1970) long ago: exit, voice, and loyalty. As Hirschman (1958, p. 5) noted, ‘Development depends not so much on finding optimal combinations for given resources and factors of production as on calling forth and enlisting for development purposes resources and abilities that are hidden, scattered, or poorly utilised’.

<sup>56</sup> Productive entrepreneurship corresponds to the creation and expansion of new firms; unproductive entrepreneurship corresponds to rent-seeking activities; destructive entrepreneurship corresponds to trafficking in illicit goods. All these forms of entrepreneurship create economic activity. However, institutions advance and societies progress only when the returns to productive entrepreneurship exceed those to unproductive and destructive entrepreneurship. Within the

overall supply of entrepreneurs in a given economy, there is strong evidence that it can influence the manner in which entrepreneurs—or entrepreneurially inclined individuals—direct their abilities. As William Baumol has noted, ‘policy can influence the allocation of entrepreneurs more effectively than it can influence its supply’.<sup>58</sup> Strategies that support development at a national scale thus must consider not only the quality of business climate in general, but also, and importantly, the way government actions affect the returns to entrepreneurship of different types.<sup>59</sup>

The challenge in designing and implementing policies to support entrepreneurship is that such policies are effective only if they shift existing incentives in a direction that leads to preferred social outcomes. In work spanning two decades, Baumol has explained that the objective of policies that support entrepreneurship is less to create entrepreneurial talent than it is to affect the allocation of that talent among productive, unproductive, and destructive options.<sup>60</sup>

This observation has important empirical implications. For example, while microfinance has, over the past three decades, proven to be an effective tool to allow people to gain control over their own income, it has not unleashed the innovation and capital flow required to help stimulate growth. Micro-loans only rarely fuel the creation and growth of entrepreneurial ventures.<sup>61</sup> Though there is no doubt that the availability of finance does facilitate entrepreneurship; contrary to popular belief, financing is not the primary obstacle to entrepreneurship. The primary obstacle is action (or inaction) by government that has the unintended consequence of directing entrepreneurial talent—whether in rural areas or at the heart of major cities—from productive activities to unproductive or destructive activities.

As seen in the West and increasingly in emerging markets, such growth comes from high-growth businesses such as Wal-Mart, Microsoft, Infosys etc., which have created millions of jobs and generated billions in revenues.<sup>62</sup> A country’s success in supporting such ‘Schumpeterian entrepreneurship’ is reflected directly in the number of new but rapidly growing companies it produces. In Pakistan, firms with fewer than ten employees employ nearly 80 per cent of the non-agricultural workforce but contribute only 30 per cent of GDP—figures that have remained largely unchanged for the past two decades.<sup>63</sup> In contrast, small firms in developed countries typically are less dominant in terms of employment but they contribute a greater share of GDP; small and growing firms also contribute to economic growth to an extent disproportionate with their size.

Furthermore, today as in the past, there is no viable bridge linking small and large firms. Small family businesses are essentially precluded from growing into large groups, while large corporations rarely invest in small enterprises. Even buyer-supplier relationships with subcontractors—key to the functioning of large firms in advanced industrialised countries—in most industries are either poorly developed or non-existent. The economic environment lacks—in addition to trust—an ecosystem

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category of ‘productive entrepreneurship’, it is possible to differentiate further between ‘opportunity entrepreneurship’ and ‘necessity entrepreneurship’.

<sup>57</sup> WJ Baumol, ‘Entrepreneurship: Productive, Unproductive, and Destructive’, *The Journal of Political Economy*, vol. 98, no. 5(1), 1990, pp. 893-921

<sup>58</sup> Ibid.

<sup>59</sup> EP Auerswald and Z Acs, ‘Defining Prosperity’, *The American Interest*, May-Jun, 2009, pp. 4-13.

<sup>60</sup> WJ Baumol, ‘A Micro theory of Innovative Entrepreneurship’, Princeton University Press, Princeton, NJ, 2010

<sup>61</sup> Microfinance institutions (MFIs) today provide services to over 150 million clients across the globe, with wide variation in models used and outcomes achieved. Assessments of micro-lending have tended to focus on high repayment rates rather than on promoting borrower welfare. See, e.g., Banerjee et al. (2009), and Zinman and Karlan (2009)

<sup>62</sup> In low-income countries, the contributions to economic output and employment made by formally registered small and mid-sized enterprises (SMEs) are less than one-third of those made by their counterparts in high-income countries. This disparity is evidence of impediments that exist in poor places to the development of high-growth enterprises.

<sup>63</sup> Federal Bureau of Statistics, Statistics Division, Government of Pakistan

that connects the various levels of the private sector—large corporations, innovative high-growth firms and micro-enterprises. The challenge, for Pakistan, is how to bring all of those into an ecosystem where they're working and reinforcing one another.

### Implications for Economic Strategy

A strategic imperative for Pakistan, as for governments around the world, is in the design and implementation of policies and programs that encourage entrepreneurship in general, and the creation of high-growth firms in particular—rewarding rather than penalising entrepreneurs who are successful in providing new and innovative goods and services.

Contrary to widespread belief, a national economic strategy emphasising development led by entrepreneurship is not the same as a strategy emphasising either support for small- and medium-enterprises (SMEs) or improvements in the 'business climate'. While all new and rapidly growing firms fall, at first, into the category of SMEs, it is important to note that implementing strategies to accelerate entrepreneurship is not the same as building institutions to support SMEs. SMEs are small, but they are not necessarily new or growing. Schumpeterian ventures are new and innovative, but when successful they do not remain small for long. Indeed, programs to support SMEs, if improperly conceived and implemented, may actually undermine entrepreneurship if they diminish incentives for innovation and growth-directed strategies—for example, by creating a program of subsidies not available to firms that grow beyond a certain size.<sup>64</sup>

Support for entrepreneurship and innovation is often confused with generic strengthening of the 'business climate'. However, the business climate pertains to all firms—both incumbents and new entrants. Some elements of the business climate (for example, the time required to register a new business or the difficulty of obtaining business licenses) are relevant to entrepreneurship. However, others (for example, the stability of the financial sector) may actually imply the concentration of market power. Given that development depends on the decisions made by entrepreneurs to allocate their talent to productive activities rather than unproductive (rent-seeking) or destructive ones, effective development planning begins with consideration of two key questions:

1. What actions does government take (or fail to take) that affect the incentives of entrepreneurs?
2. How can the government adjust its actions to increase the allocation of entrepreneurial talent to productive activities?

These two questions suggest a domain of inquiry that spans almost every dimension of government activity at the federal, provincial, and local level—from fiscal and monetary policy, to land use and urban planning, legal protections and antitrust policies. Effective actions must connect this broad domain of inquiry to specific areas of work.

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<sup>64</sup> D Stangler, 'High-Growth Firms and the Future of the American Economy', Kauffman Foundation Research Series, 2010

## Annexure 2

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### Core Research Team

The research team was led by Dr. Nadeem Ul Haque, Deputy Chairman, Planning Commission. This report builds upon his earlier work conducted on entrepreneurship reforms in Pakistan during his stay as Vice Chancellor of Pakistan Institute of Development Economics. Key research inputs on international experiences were provided by Philip Auerswald and Jaffer Qamar. The research team members from Planning Commission included Vaqar Ahmed, Sana Shahid, and Haroon Sarwar.