



Kauffman Foundation Research Series:  
Expeditionary Economics

## Entrepreneurship and the Process of Development: A Framework for Applied Expeditionary Economics in Pakistan

February 2012, 5th in the Series

Robert Looney  
Naval Postgraduate School

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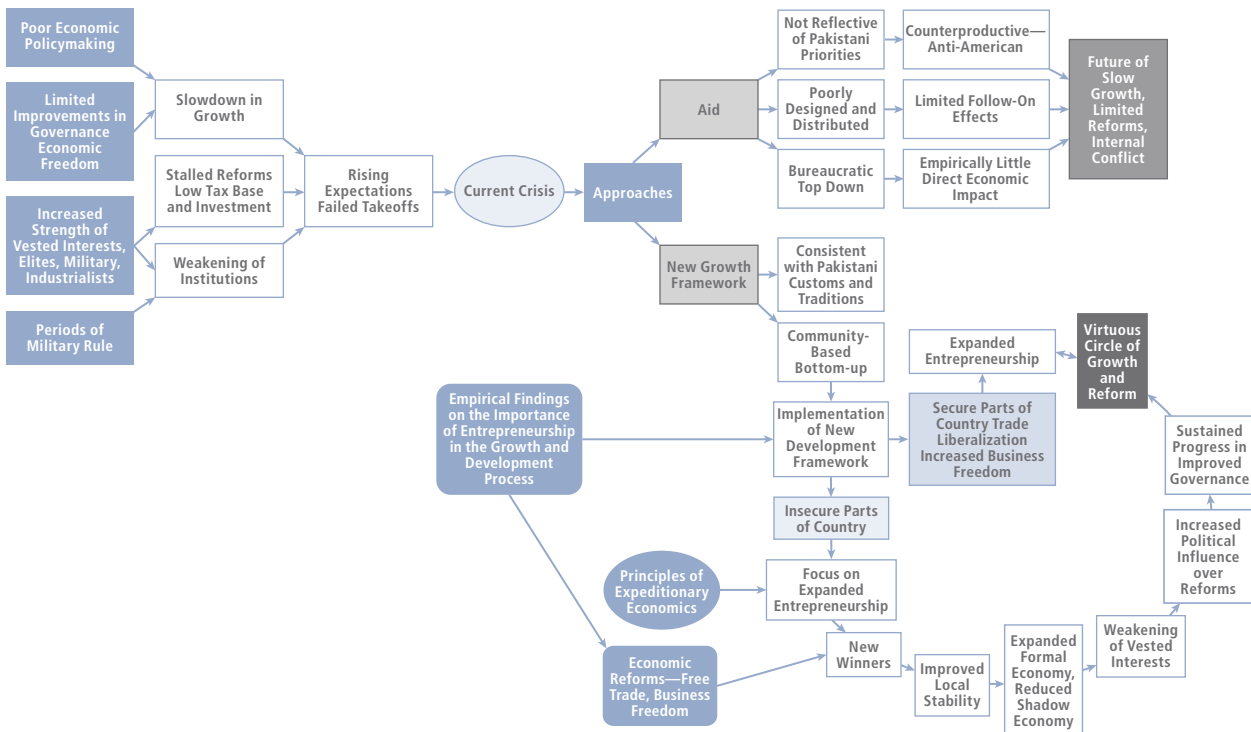
## Executive Summary

The purpose of this study is to develop an empirically based model to serve as a starting point for designing development strategies for Pakistan and similar countries, where aid has produced few tangible gains and the economy has not been able to generate sustained periods of growth. Within this framework, the model seeks to integrate into the entrepreneurship-led growth strategy of Expeditionary Economics several related but diverse strands of research: the literature on governance and economic growth, factors underpinning entrepreneurship, and the diverse forces contributing to instability. The hope is that ultimately the analysis will yield a plan of action and a way of identifying the sequencing of reforms that can be applied to a wide variety of conflict/post-conflict settings in the developing world.

The study found that:

1. It is unlikely in Pakistan’s current institutional/political setting that traditional aid programs, even with greatly expanded funding, could initiate a process of institutional development and reform sufficient to offset Pakistan’s current slow growth and cycle of violence (see Fig. ES-1).
2. However, an extensive quantitative assessment of successful country growth patterns found that entrepreneurial activity is a key element in driving the growth process through progressive stages of economic development.

Fig. ES-1. Report Overview



3. Successful countries whose development relies on increased entrepreneurial activity appear to sustain growth through a series of ongoing reforms initiated by this growing stakeholder group. As a result, they are able to establish virtuous circles of increased economic liberalization, extended entrepreneurship, expanded growth, and improved governance, which lead in turn to further growth and development.
4. Increased trade liberalization and improvements in the business climate are the most important factors for stimulating entrepreneurial expansion for countries at Pakistan's stage of development.
5. Consequently, entrepreneurial efforts could be expanded in the short term without major improvements in governance.
6. Entrepreneurship-led development could potentially create a virtuous circle of growth and reform in Pakistan capable of overcoming the constraints of violence, bureaucratic inertia, and the country's many vested interests.
7. In principle, Pakistan's New Growth Framework incorporates all of the elements noted above.
8. Drawing on these findings, the principles of Expeditionary Economics should facilitate a policy shift toward the New Growth Framework, especially in areas where the central government has thus far been unable to be an effective agent for economic betterment.
9. There are numerous opportunities for the United States and European Union to contribute to Pakistan's economic revival and sustained growth.

*A trend setter in Asia up to the sixties, economic management in Pakistan has steadily deteriorated to the point where the economy has, for the past few decades, lurched from one financial crisis to the next. At the heart of the problem has been the poor management of public finances and deep-seated unresolved structural issues in the economy that bad management and poor governance has exacerbated. The consequences of this secular decline in economic governance are plain to see: macroeconomic instability, high inflation, poor public services, criminal neglect of the social sectors, widespread corruption, crippling power outages, growing unemployment, deepening poverty and a deteriorating debt profile.<sup>1</sup>*

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1. Meekal Ahmed, "An Economic Crisis State?" in *Pakistan: Beyond the Crisis State*, ed. Maleeha Lodhi (New York: Columbia University Press, 2011), 169.

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## Introduction

As one of the central countries in the United States' "War on Terror," Pakistan's stability has global import. Unfortunately, this stability is increasingly threatened by the restlessness of tribal groups in areas bordering Afghanistan, the continued dispute with India over Kashmir, and internal discontent among various factions within the government and population. Without sustained economic growth and major improvements to its security and institutions, Pakistan's situation will likely continue to deteriorate, impairing efforts to bring stability to Afghanistan and to South Asia as a whole.<sup>2</sup>

Most observers are pessimistic about Pakistan's near-term future. A leading expert, Stephen Cohen, suggests that: "Over the next five years, Pakistan's success as a stable state, measured along any dimension, is far from guaranteed, and in fact, the 'normalization' of Pakistan remains doubtful."<sup>3</sup> Cohen concludes that, under the most probable scenario, Pakistan will continue to struggle with a chronically deteriorating economy and ever-pressing political and regional security challenges.

A recent Rand report echoes Cohen's assessment, concluding that the near-term future will see a "Pakistan that 'muddles' along, neither failing outright nor managing to right its course."<sup>4</sup>

According to the report, future scenarios range from the emergence of an increasingly technocratic state, to an Islamist state, to the breakup of the state along regional and factional lines—any of which would exacerbate regional instability. In the most likely scenario, Pakistan will evolve into an "authoritarian state tightly under the control of the military and intelligence agencies."<sup>5</sup>

Shahid Javed Burki sees direct links between the recent rise of extremism in Pakistan and rapid increases in population, coupled with economic mismanagement. He suggests that the government's focus should have been "not only on getting the economy to grow rapidly—which it did on occasions and during the periods when the military was in charge—but also on ensuring that the rewards of rapid growth were widely distributed."<sup>6</sup> The failure to do so has spawned "millions of alienated youth with little faith in their future. They have been successfully recruited to jihadist causes. The latest of these is the destruction of the Pakistani state."<sup>7</sup>

Failure to prudently distribute the rewards of growth has been only one of many weaknesses in Pakistan's development policies. Pakistan is plagued by a long-term pattern of economic stops and starts<sup>8</sup> and failed takeoffs,<sup>9</sup> in which rapid growth is followed by periods of relative stagnation.<sup>10</sup> Contributing to this pattern is a lack of effective governance, in which reforms are stifled by entrenched elites who benefit from the status quo.<sup>11</sup> Unless governance can be improved,

2. Robert Looney and Robert McNab, "Pakistan's Economic and Security Dilemma: Expanded Defense Expenditures and the Relative Governance Syndrome," *Contemporary South Asia* (March 2008): 63.

3. Stephen Cohen, "Keeping Pakistan From Falling Apart," *World Politics Review* (May 2011): 1.

4. C. Christine Fair, et al., *Pakistan: Can the United States Secure an Insecure State?* (Santa Monica, CA: Rand, 2010), xv.

5. Ibid.

6. Shahid Javed Burki, "Roots of Terrorism," *Dawn*, December 15, 2009.

7. Ibid.

8. Robert Looney, "Pakistan's Economy: Achievements, Progress, Constraints and Prospects" in *Pakistan: Founders' Aspirations and Today's Remedies*, ed. Hafeez Malik (Karachi: Oxford University Press, 2001), 196–243.

9. Looney, "Failed Economic Take-offs and Terrorism in Pakistan: Conceptualizing a Proper Role for U.S. Assistance," *Asian Survey* (November/December 2004): 771–93.

10. Looney, "Failed Take-Off: An Assessment of Pakistan's October 2008 Economic Crisis," Pakistan Security Research Unit (PSRU), Brief No. 46, University of Bradford, April 21, 2009.

11. Burki, "Pakistan's New Political Economy," *Business Standard*, April 22, 2011.



it will continue to pose a formidable barrier to sustained growth.<sup>12</sup>

It is becoming increasingly clear that traditional foreign aid is not the solution. Not only have massive infusions of foreign aid failed to bring stability to Pakistan or buy goodwill for the United States,<sup>13</sup> but the way these programs are managed has corrupted and corroded the country's institutions.<sup>14</sup> The top-down nature of traditional aid programs has encouraged corruption and rent seeking, while lessening the need for the government to forge a bond with its citizens by raising revenues and redistributing those funds as services.<sup>15</sup> Civilian aid programs have little effect on the overall Pakistani economy, as illustrated by a recent estimate that U.S. withdrawal of these funds would have only a 0.14 percent impact on the GDP growth rate.<sup>16</sup> The outcomes of foreign aid have been so unsatisfactory that both donor and recipient groups agree that, in many respects, Pakistan would have been better off without them.<sup>17</sup>

While few hold out hope that traditional U.S. foreign aid can change the direction of events in Pakistan, the new area of Expeditionary Economics could potentially provide a basis for cooperation between the two countries in their mutual quest for stability. As described in Carl J. Schramm's pathbreaking article, Expeditionary Economics begins with the premise that "economic growth is critical to

establishing social stability, which is the ultimate objective of...counterinsurgency campaigns and disaster-relief efforts."<sup>18</sup> As Schramm notes, proven methods for achieving such economic growth already exist in "the entrepreneurial model practiced in the U.S. and elsewhere."<sup>19</sup>

Nadeem ul Haque of Pakistan's Planning Committee laments that the "gyrations of politics and security have kept everyone fully engaged—in fact, more than fully—and issues of long-term development planning have been neglected not only by the media but in the public imagination."<sup>20</sup> He sees this situation as particularly ironic given that the state of the economy and its advancement are far more likely to affect politics and security than vice versa.<sup>21</sup> One of a growing number of Pakistani economists who, like Schramm, champions the replacement of the country's inefficient, state-run policies with entrepreneur-led growth, ul Haque observes:

*An unintended consequence of our past policies has been the stifling of internal markets, cities and communities, which play a critical role in fostering productivity, innovation and entrepreneurship and ultimately promote growth, prosperity and development. ... In the new development framework, the private sector should be the growth-driver in open market environment that rewards efficiency, innovation and entrepreneurship, while the government is facilitator that protects public interests and*

12. Looney and McNab, "Pakistan's Economic and Security Dilemma: Expanded Defense Expenditures and the Relative Governance Syndrome," *Contemporary South Asia* (March 2007): 63–82.

13. Griff Witte, "U.S. Aid Buys Little Goodwill: Pakistanis Say They See Scant Evidence of the Billions Spent," *The Washington Post*, August 24, 2010, A1.

14. Fair, "A Better Bargain for Aid to Pakistan," *The Washington Post*, May 30, 2009.

15. Ibid.

16. Ben Arnoldy and Assam Ahmed, "U.S. Cuts Aid to Pakistan: Six Key Questions," *The Christian Science Monitor*, July 11, 2011.

17. Nancy Birdsall and Molly Kinder, "The U.S. Aid 'Surge' to Pakistan: Repeating a Failed Experiment? Lessons for U.S. Policymakers from the World Bank's Social-Sector Lending in the 1990s (Working Paper No. 205, Center for Global Development, March 2010); Burki, "Living Without Foreign Assistance," *Dawn*, May 23, 2011.

18. Carl J. Schramm, "Expeditionary Economics," *Foreign Affairs* (May/June 2010).

19. Ibid.

20. Nadeem ul Haque in Adil Najam, "Devising A New Growth Strategy for Pakistan (7): New Growth Framework Approved," *All Things Pakistan*, May 29, 2011.

21. Ibid.

*rights, provides public goods, enforces laws, punishes exploitative practices, and operates with transparency and accountability.*<sup>22</sup>

This sentiment lies at the core of the Pakistani Planning Commission's New Growth Framework, which was formally adopted by the National Economic Council in May 2011. The framework represents a paradigm shift in Pakistan's approach toward the economy. It proposes that the country move from the current state-led model of development to one that relies on freely functioning markets with dynamic entrepreneurship playing the leading role in expanding investment, developing new areas of economic activity, and providing productive employment for the country's rapidly burgeoning labor force. While the framework is intuitively appealing to professional economists, it is admittedly theoretical at this point and, as such, has drawn criticism that it offers a list of "what to do," as opposed to "how to do."<sup>23</sup> Critics also note that it is vague regarding the sequencing of its policies and reforms<sup>24</sup> and question whether Pakistan's government has the ability and political will to implement such an ambitious agenda.<sup>25</sup>

Criticisms aside, the key assumptions of the framework are basically sound. In fact, countries whose circumstances resembled those of Pakistan have implemented similar programs that initiated a cumulative process of growth and reform.<sup>26</sup> Many Central and Eastern European countries that successfully transitioned from communism followed programs that shared key assumptions and elements espoused by both the New Growth Framework and Expeditionary Economics.

Pakistan's New Growth Framework emphasizes theory, while Expeditionary Economics focuses

on the nuts-and-bolts implementation of these economic principles by the military in conflict and post-conflict settings. However, in their basic philosophies and economic approaches, the two are essentially complementary. Both stress the importance of growth as a means to achieving objectives such as stabilization. Both see the entrepreneur as a key figure in the process of growth, with the state remaining in the background as a supporting player. Integrating the two approaches could potentially provide a blueprint for stimulating entrepreneurship-led growth to improve stability and security in Pakistan and other developing countries.

Key to integrating the New Growth Framework with Expeditionary Economics is the development of a model that places both on a sound empirical footing. As previously noted, the New Growth Framework is vague with regard to the proper sequencing of policies and reforms. Similarly, much of the literature on entrepreneurship, a key component of Expeditionary Economics, is vague or anecdotal in linking policy actions to new firm startups and increased entrepreneurial activity, making it difficult to transfer its strategies to different settings.

A major goal of the present study is to develop an empirical model to serve as a starting point for designing development strategies for countries like Pakistan, where aid has produced few tangible gains and the economy has not been able to generate sustained periods of growth. More generally, the model seeks to integrate into Expeditionary Economics several related but diverse strands of research: the literature on governance and economic growth, factors underpinning entrepreneurship, and the diverse forces contributing to terrorism/extremism. Ultimately, it is hoped that the analysis

22. ul Haque, "Devising a Growth Strategy for Pakistan (2): Towards a New Development Approach," *All Things Pakistan*, February 5, 2011.

23. Abid Hasan, "An Unorthodox Path to Prosperity," *The News*, July 4, 2011.

24. Safiya Aftab, "The Elusive Quest for Sustainable Growth," *The Friday Times*, May 6, 2011.

25. Pervez Tahir, "A 'New' Growth Strategy," *The Express Tribune*, February 11, 2011.

26. See, for example, Oleh Havrylyshyn and Thomas Wolf, "Determinants of Growth in Transition Countries," *Finance & Development* (June 1999); and Pradeep K. Mitra and Marcelo Selowsky, "Lessons from a Decade of Transition in Eastern Europe and the Former Soviet Union," *Finance & Development* (June 2002).

will yield a plan of action and a way of identifying the sequencing of reforms that will be applicable to a wide variety of conflict/post-conflict settings in the developing world.

To that end, this report begins with an overview of the various elements constraining Pakistan's growth, as well as the factors leading up to Pakistan's current crisis. Next, it offers a model that integrates the principles of the New Growth Framework with Expeditionary Economics and tests whether and how entrepreneurship-led development could initiate a virtuous circle of economic growth, reform, and reduced violence in Pakistan. Finally, it examines two contrasting solutions: expanded foreign aid programs and implementation of the New Growth Framework discussed above.

## Potential Constraints on Pakistan's Economic Advancement and Entrepreneurial Activity

To develop an analytical framework for applying Expeditionary Economics to Pakistan and other conflict/post-conflict countries, it is first necessary to identify the constraints with the greatest potential to impede the country's progress at each stage of development. In Pakistan's case, the list is long. A cursory survey of the literature suggests a myriad of inhibiting factors. Those most frequently identified as key development constraints include (1) lack of competitiveness due to limitations in factors ranging from infrastructure

to education to technological capacity, (2) limited governance in areas such as rule of law and anticorruption, and (3) insufficient economic reforms that hinder open markets and trade.

Each of these broad categories is made up of a number of individual variables, which are explored in depth below. The examination of the variables is instructive, both in illuminating the wide range of constraints the Pakistani economy faces and in illustrating the diversity of opinion as to the paramount factor or factors that inhibit Pakistani growth and development.

### Potential Competitiveness Constraints

The World Economic Forum's Global Competitiveness Index (WEF GCI) provides an excellent starting point for examining Pakistan's inability to sustain long-term growth. Drawing on the work of Harvard's Michael Porter,<sup>27</sup> the index provides a benchmark for identifying impediments to a country's competitiveness.<sup>28</sup> The GCI takes into account macroeconomic as well as the core microeconomic foundations of national competitiveness, which it defines as "the set of institutions, policies, and factors that determine the level of productivity and thus income of a country."<sup>29</sup>

The WEF's approach depicts global competitiveness as a weighted average of many different components, each of which affects some aspect of competitiveness. These components fall into twelve main groups, or "12 pillars of competitiveness."<sup>30</sup> These pillars are: Institutions, Infrastructure, The Macroeconomic Environment, Health and Primary Education, Higher Education

27. See, for example, Michael Porter, "Enhancing the Microeconomic Foundations of Prosperity: The Current Competitiveness Index," in *The Global Competitiveness Report 2001–2002*, ed. Klaus Schwab (Geneva: World Economic Forum, 2001); and Michael Porter, "The Microeconomic Foundations of Prosperity: Findings from the Business Competitiveness Index," in *The Global Competitiveness Report 2007–2008*, ed. Klaus Schwab (Geneva: World Economic Forum, 2007).

28. Xavier Sala-i-Martin, et. al., "The Global Competitiveness Index: Measuring the Productive Potential of Nations," in *The Global Competitiveness Report, 2007–2008*, ed. Klaus Schwab (Geneva: World Economic Forum, 2007), 3.

29. Klaus Schwab, preface to *The Global Competitiveness Report 2010–2011*, ed. Klaus Schwab (Geneva: World Economic Forum, 2010), 4.

30. Ibid.

and Training, Goods Market Efficiency, Labor Market Efficiency, Financial Market Development, Technological Readiness, Market Size, Business Sophistication, and Innovation.

Following Porter's<sup>31</sup> earlier work, the WEF further assumes that countries progress through three distinct stages: (1) factor driven, (2) investment driven, and (3) innovation driven. Using regression analysis, the forum has found that certain pillars are more important at one stage than at others. Institutions, Infrastructure, Macroeconomic Stability, and Health and Primary Education are key in the factor-driven stage. Higher Education and Training, Goods Market Efficiency, Labor Market Efficiency, Financial Market Sophistication, Technological Readiness, and Market Size predominate during the efficiency-driven stage. Business Sophistication and Innovation play a critical role in the innovation-driven stage.

Drawing on this framework, the WEF is able to classify individual countries into one of these three stages. Each country is assigned to a development stage based on (1) its level of GDP per capita measured at market exchange rates—a proxy for wages (used by the WEF because internationally comparable data on wages and purchasing power parity are not available for all countries covered)—and (2) the extent to which countries are factor driven, as proxied by the share of exports of primary goods in total exports.

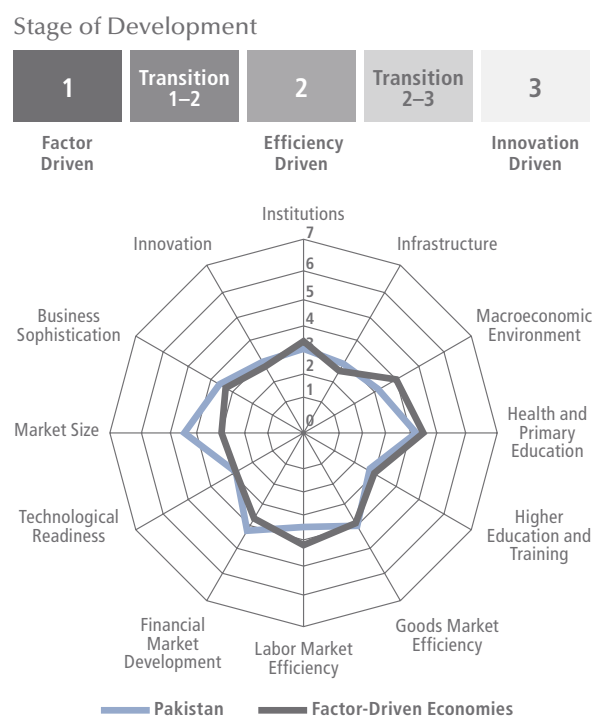
The forum deems countries falling between two stages as “in transition.” As these countries develop, increasingly more weight is given to the pillars that will assure their competitiveness when they move on to the next development stage. In this way, the GFI rewards countries that do what is needed to ensure a smooth transition and penalizes those that fail to prepare for the next stage. Table 1 provides a summary of the latest (2010) World Economic Forum stage

classifications. For the purposes of this report and its empirical model, the WEF stages have been relabeled as Groups 1 through 5, as indicated in parentheses under the main headings on Table 1.

As illustrated in Fig. 1, Pakistan's progress toward improved competitiveness has been limited. According to the WEF's 2010–2011 Global Competitiveness Report:

*Pakistan falls to 123rd place, weakening across most areas measured by the GCI. Still at an early stage of development, the country will require efforts in particular to improve the basic determinants of its competitiveness, namely its institutions (112th), infrastructure (110th), and macroeconomic environment (133rd) as well as education at all levels.<sup>32</sup>*

Fig. 1. Pakistan's Progress in Improved Competitiveness



Source: World Economic Forum, *The Global Competitiveness Report 2010–2011*, 268.

31. Porter, “Enhancing the Microeconomic Foundations of Prosperity.”

32. *The Global Competitiveness Report 2010–2011* (Geneva: World Economic Forum, 2010), 30.

Table 1. Countries at Various Stages of Development 2010–2011

Stage 1 (Group 1)	Transition From 1 to 2 (Group 2)	Stage 2 (Group 3)	Transition From 2 to 3 (Group 4)	Stage 3 (Group 5)
Bangladesh	Algeria	Albania	Bahrain	Australia
Benin	Armenia	Argentina	Barbados	Austria
Bolivia	Azerbaijan	Bosnia	Chile	Belgium
Burkina Faso	Botswana	Brazil	Croatia	Canada
Burundi	Brunei	Bulgaria	Estonia	Cyprus
Cambodia	Egypt	Cape Verde	Hungary	Czech Republic
Cameroon	Georgia	China	Latvia	Denmark
Chad	Guatemala	Colombia	Lithuania	Finland
Cote d'Ivoire	Guyana	Costa Rica	Oman	France
Ethiopia	Indonesia	Dominican Republic	Poland	Germany
Gambia, The	Iran, Islamic Rep.	Ecuador	Puerto Rico	Greece
Ghana	Jamaica	El Salvador	Slovak Republic	Hong Kong SAR
Honduras	Kazakhstan	Jordan	Taiwan, China	Iceland
India	Kuwait	Lebanon	Trinidad and Tobago	Ireland
Kenya	Libya	Macedonia	Uruguay	Israel
Kyrgyz Republic	Morocco	Malaysia		Italy
Lesotho	Paraguay	Mauritius		Japan
Madagascar	Qatar	Mexico		Korea, Rep
Malawi	Saudi Arabia	Montenegro		Luxembourg
Mali	Sri Lanka	Namibia		Malta
Mauritania	Swaziland	Panama		Netherlands
Moldova	Syria	Peru		New Zealand
Mongolia	Ukraine	Romania		Norway
Mozambique	Venezuela	Russian Federation		Portugal
Nepal		Serbia		Singapore
Nicaragua		South Africa		Slovenia
Nigeria		Thailand		Spain
Pakistan		Tunisia		Switzerland
Philippines		Turkey		United Arab Emirates
Rwanda				United Kingdom
Senegal				United States
Tajikistan				
Tanzania				
Timor Leste				
Uganda				
Vietnam				
Zambia				
Zimbabwe				

Source: Xavier Sala-i-Martin, et al., "The Global Competitiveness Report 2010–2011: Looking Beyond the Economic Crisis" in *The Global Competitiveness Report 2010–2011*, ed. Klaus Schwab (Geneva: World Economic Forum, 2010), 11.

On this basis, Pakistan falls into Group 1, the initial, factor-driven stage of development.

Since the early to mid-1990s, Pakistan’s competitive shortcomings have resulted in slowed economic growth relative to other developing countries in Asia (see Fig. 2). While the country managed to achieve a short spurt of growth in the early to mid-2000s, this expansion was largely consumption-demand-driven, rather than the result of a major increase in investment-led productivity.

Even worse, this period of growth appears to have compounded many of the problems plaguing Pakistan today. While no detailed studies of income distribution are available for the last several years of Musharraf’s regime, Burki estimates that around 10 million Pakistanis benefitted from the economic growth and restructuring, 25 million would have entered the system had it not been disrupted, and 45 million were completely ignored.<sup>33</sup> Furthermore, he notes that regional inequality emerged from the Musharraf era, whose benefits were largely confined to the central and northern Punjab and large cities such as Islamabad, Lahore, Karachi, Faisalabad, and Gujranwala.<sup>34</sup>

In addition to global competitiveness, the recent literature on failed states notes that development

may be affected by deeper determinants of growth, including governance variables such as corruption, political stability, and the rule of law.<sup>35</sup> Another body of literature observes that the various dimensions of economic freedom (or the lack thereof) have had a profound effect on the progress of Pakistan and many other countries.<sup>36</sup> Such studies suggest that, besides the WEF’s twelve competitiveness components, there are additional factors that must be addressed before Pakistan can embark on a path of sustained growth.

### Limited Institutional Development: Governance

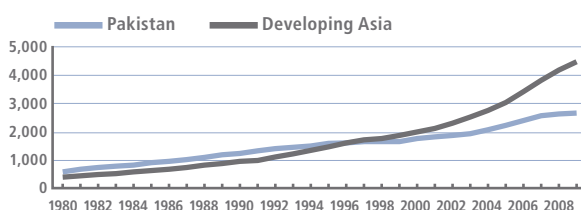
While rating countries on the basis of their relative progress in improving governance is inherently subjective, the World Bank<sup>37</sup> regularly provides a set of rankings incorporating the full extent of our knowledge about this phenomenon. The World Bank dataset estimates six dimensions of governance for 213 economies over the period 1996–2009. These dimensions are: Voice and Accountability, Political Stability and Absence of Violence, Government Effectiveness, Regulatory Quality, Rule of Law, and Control of Corruption. The values for each of the governance figures range from a low of -2.5 to a high of +2.5, with a country sample mean of zero.

The means for the five-group sample for 2009 (Table 2) show a fairly steady progression on each governance dimension, from low for Group 1 to high for Group 5. The one notable exception to the pattern is a drop in the Voice and Accountability dimension as countries move from Group 1 to Group 2.

Pakistan scores low relative to other Group 1 countries on most governance dimensions: -0.997 on Voice and Accountability versus a Group 1 average of -0.547; -2.756 on Political Stability/

Fig. 2. Per-Capita Income in Pakistan and Developing Asia

GDP (PPP) Per Capita (Int’l \$), 1980–2009



Source: World Economic Forum, *The Global Competitiveness Report 2010–2011*.

33. Burki, “Arithmetic of Discontent,” *Dawn*, December 11, 2007.

34. Burki, “Reaching the Disadvantaged,” *Dawn*, December 18, 2007.

35. Dani Rodrik and Mark Rosenzweig, “Development Policy and Development Economics: an Introduction,” in *Handbook of Development Economics*, Vol. 5, eds. Dani Rodrik and Mark Rosenzweig (Amsterdam: North Holland, 2009).

36. See, for example, J. Gwartney, J. Hall, and R. Lawson, *Economic Freedom of the World 2000 Annual Report* (Vancouver: Fraser Institute, 2000).

37. World Bank Governance Indicators.



Absence of Violence versus -0.685; -0.934 on Government Effectiveness versus -0.714; -0.925 on Rule of Law versus -0.761; and -1.097 on Control of Corruption versus -0.731. Pakistan surpasses the Group 1 mean only in its Regulatory Quality, on which it scored -0.499 versus -0.562 for Group 1 countries as a whole. This score notwithstanding, poor governance places severe constraints on Pakistan's growth.

These constraints are further exacerbated by Pakistan's high defense spending. Looney and McNab found that countries with high levels of governance and institutional quality, whose defense expenditures make up a relatively low share of GDP, may experience increased rates of growth if defense spending is expanded. Conversely, in countries like Pakistan with poor institutional

quality as proxied by governance indicators such as voice and accountability, expanding already high levels of defense expenditures has a negative growth impact.<sup>38</sup> As a result, without governance reforms, increased security spending to combat domestic terrorism could hamper Pakistan's growth even more severely.

Interestingly, one school of thought contends that Pakistan's deficient governance structures may themselves be a major contributing factor to terrorism and instability. In an early study of terrorism, Alan Krueger and Jitka Maleckova came to the surprising conclusion that a reduction in poverty in and of itself, or an increase in educational attainment, would not meaningfully reduce terrorism. Their main finding was that any connection between poverty, education, and

Table 2. Group Means on Governance Dimensions, World Economic Forum Development Stages, 2010–2011

	World Economic Forum Stages	Voice	Political Stability	Government Effectiveness	Regulatory Quality	Rule of Law	Control of Corruption
1	Mean	-0.547	-0.685	-0.714	-0.562	-0.761	-0.731
	Number of Countries	38	38	38	37	30	38
	Std. Deviation	0.557	0.813	0.389	0.443	0.451	0.388
	<b>Pakistan</b>	<b>-0.997</b>	<b>-2.756</b>	<b>-0.933</b>	<b>-0.499</b>	<b>-0.925</b>	<b>-1.097</b>
2	Mean	-0.739	-0.300	-0.267	-0.278	-0.415	-0.402
	Number of Countries	25	25	25	22	22	25
	Std. Deviation	0.649	0.787	0.582	0.710	0.552	0.723
3	Mean	0.015	0.175	0.061	0.137	0.223	0.165
	Number of Countries	29	29	29	29	23	29
	Std. Deviation	0.620	0.666	0.412	0.453	0.545	0.442
4	Mean	0.657	0.598	0.802	0.902	0.720	0.572
	Number of Countries	15	15	15	15	13	15
	Std. Deviation	0.680	0.320	0.303	0.331	0.378	0.456
5	Mean	1.127	0.761	1.462	1.358	1.443	1.488
	Number of Countries	32	32	32	32	28	32
	Std. Deviation	0.547	0.558	0.430	0.350	0.454	0.661
Total	Mean	0.051	-0.038	0.183	0.240	0.109	0.097
	Number of Countries	139	139	139	138	116	139
	Std. Deviation	0.932	0.882	0.932	0.886	0.989	1.006

Source: World Economic Forum: *The Global Competitiveness Report, 2010–2011* (Geneva: World Economic Forum, 2010).

38. Looney and McNab, "Pakistan's Economic Security Dilemma."

terrorism is indirect, complicated, and probably quite weak. Instead of viewing terrorism as a direct response to limited market opportunities or ignorance, they suggest that terrorism is a response to political conditions and long-standing feelings, either perceived or real, of indignity and frustration.<sup>39</sup> While subsequent studies have refined this position, Krueger and Maleckova's findings are still the starting point in country-by-country assessments of the factors contributing to terrorism.<sup>40</sup>

### Voice and Accountability

In the critical area of Voice and Accountability, Pakistan scores the lowest of the South Asian countries (see Fig. 3). Despite steady improvement in the post-Musharraf years, which saw the country rise from the 11th percentile in 2000 to 21st by 2009, it still lagged below the 2009 Asian average<sup>41</sup> of 36th percentile and India's 60th percentile.

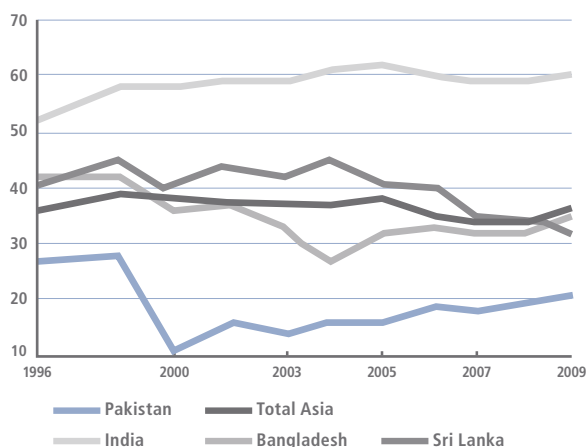
Pakistan's inability to achieve greater voice and accountability no doubt contributes to the

country's current economic malaise. Burki<sup>42</sup> contends that, as a result, the political system has not been able to find a way to reconcile the different economic interests of the country's various competing groups. For example, the ruling Pakistan Peoples Party opposes the levying of taxes on its strong agricultural base, while the Karachi-based Muttahida Qaumi Movement argues against taxing urban services, and the Pakistan Muslim League (Nawaz) favors tax protection for the merchant class. The resulting political stalemate means that no new forms of direct taxation are available to the country.<sup>43</sup>

### Political Stability/Absence of Violence

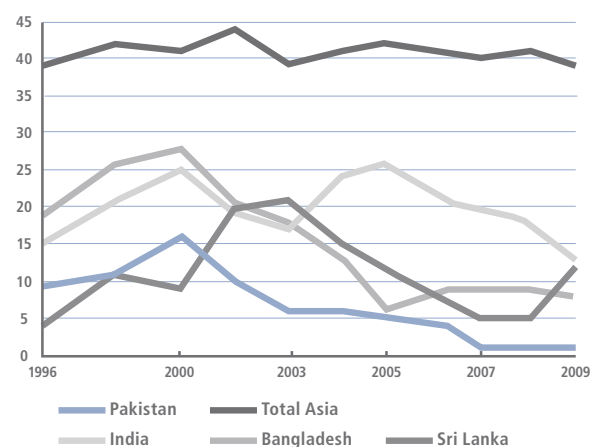
Pakistan, like the other South Asian countries, is especially deficient in political stability/absence of violence (see Fig. 4). While all four South Asian countries score considerably below the Asian average (which is not particularly high by international standards), Pakistan's score was by far the worst. From the 16th percentile in 2000, Pakistan experienced a steady decline

Fig. 3. Voice and Accountability



Source: World Bank, *Worldwide Governance Indicators*, <http://info.worldbank.org/governance/wgi/index.asp>.

Fig. 4. Political Stability, Absence of Violence



Source: World Bank, *Worldwide Governance Indicators*, <http://info.worldbank.org/governance/wgi/index.asp>.

39. Alan Krueger and Jitka Maleckova, *Education, Poverty, Political Violence and Terrorism: Is there a Causal Connection?* (Cambridge, MA: National Bureau of Economic Research, July 2002).

40. See also Krueger and Maleckova, "Education, Poverty and Terrorism: Is there a Causal Connection?" *Journal of Economic Perspectives* (Fall 2003): 119–44.

41. Asian countries included in the World Bank governance data set are: Bangladesh, Brunei, Cambodia, China, Hong Kong, India, Indonesia, Japan, North Korea, South Korea, Laos, Malaysia, Myanmar, Pakistan, Papua New Guinea, Philippines, Singapore, Sri Lanka, Taiwan, Thailand, and Vietnam.

42. Burki, "Pakistan's New Political Economy," *Business Standard*, April 22, 2011.

43. Ibid.



on this measure until it eventually leveled off at the 1st percentile in 2007. Bangladesh ranked in the 8th percentile and Sri Lanka in the 12th. As might be anticipated, empirical evidence<sup>44</sup> suggests that addressing the country's political instability is a prerequisite for further economic advancement. In addition, political instability and policy instability (see Fig. 5) ranked second and third (after corruption) as major concerns of businesses—no doubt contributing to the country's low rates of private capital formation and inflows of direct private investment.

**Government Effectiveness**

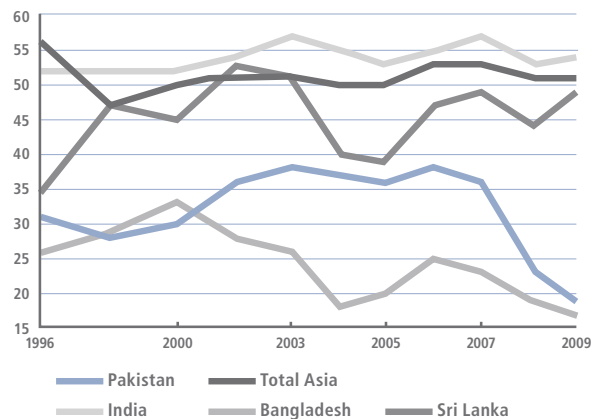
As shown in Fig. 6, Pakistan also scores low in government effectiveness, a key measure of the ability of countries to carry out development programs and effectively implement budgets. After averaging in the high thirties from 2003–2007, the country had fallen to the 19th percentile by 2009, considerably below the Asian average of 51st and India's 54th percentile.

Economist Safiya Aftab notes some of the economic shortcomings that have stemmed

from the lack of government effectiveness and decision making in recent years:

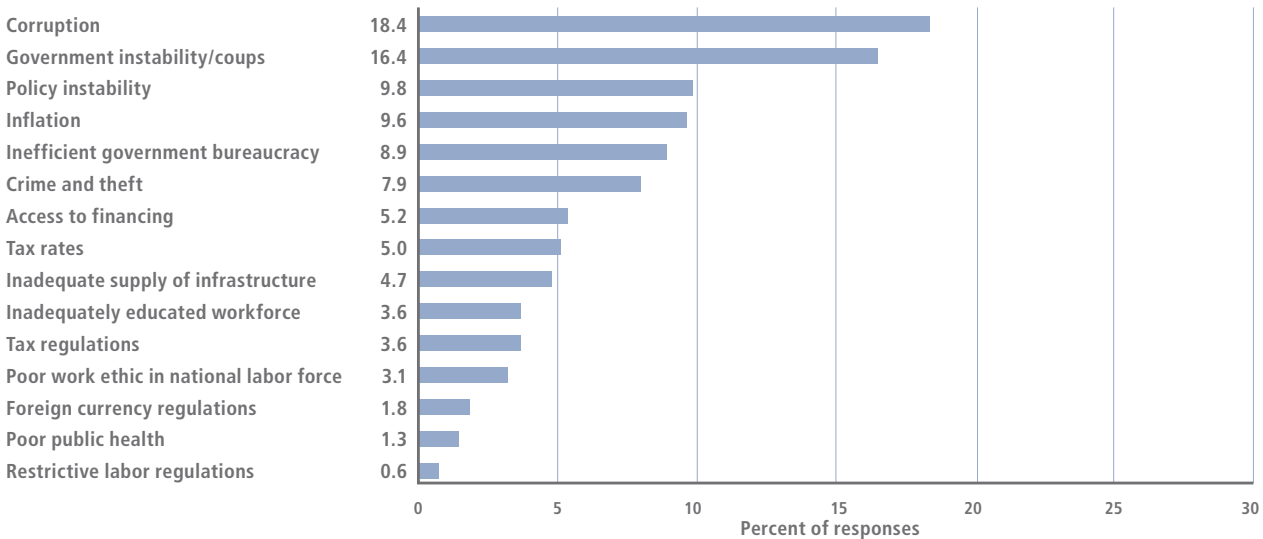
- There is no energy plan (not even a conservation strategy) and little attempt to resolve the circular debt issue that plagues

Fig. 6. Government Effectiveness



Source: World Bank, *Worldwide Governance Indicators*, <http://info.worldbank.org/governance/wgi/index.asp>.

Fig. 5. Pakistan: The Most Problematic Factors for Doing Business



Note: From a list of fifteen factors, respondents were asked to select the five most problematic for doing business in their country and to rank them between 1 (most problematic) and 5. The bars in the figure show the responses weighted according to their rankings.

Source: World Bank, *Worldwide Governance Indicators*, <http://info.worldbank.org/governance/wgi/index.asp>.

44. Muhammad Nadeem Qureshi, Karamat Ali, and Imran Rafi Khan, "Political Instability and Economic Development: Pakistan Time-Series Analysis," *International Research Journal of Finance and Economics* (2010).

the sector. Worst of all, there seems to be no planning for crises—what happens if crude oil prices spike in the short run, for example?

- Agricultural policy is supposed to be a provincial subject but the federal government doesn't seem to have even a guiding framework for the sector. It's not clear what the priorities are—is the priority to get the support price right or to invest in storage, for instance? Is the attempt to deregulate agricultural markets and set up commodity exchanges going to go anywhere, or has it been quietly shelved?
- There is no attempt to introduce new forms of direct taxation. If there is any background work on the pros and cons of imposing agricultural income tax, or different forms of capital gains taxes, it has not been made public.
- Cuts in expenditures have been made since the floods, but it is mainly development spending that has been axed, not nonsalary current expenditures.
- Cutting the Public Sector Development Projects (PSDP) is probably the right way to go, but the government needs to be more transparent about what it's going to axe and why.
- In spite of the obvious fiscal crisis, there has been little attempt to restructure loss-making state-owned enterprises. The government has given in to pressure on at least two occasions when such attempts were made in the Karachi Electric Supply Company (KESC), though the government has a minority share in the utility and Pakistan International Airlines (PIA). For the KESC, the government's action was unpardonable. Imposing on a private

entity in order to reemploy staff on the basis of a 26 percent shareholding is absurd.<sup>45</sup>

The precipitous drop in government effectiveness in recent years has led Stephen Cohen to conclude that the bureaucracy and other state structures are largely incapacitated and unable to respond to the country's demographic and economic challenges. As a result, the country's effective governance and ultimate viability now depend on a combination of massive foreign assistance and remittances of overseas Pakistanis.<sup>46</sup> Pointing to Pakistan's inclusion in the Top 10 of the Failed State Index, he predicts that the consequences will be "disastrous for future stability and governance, translating into a chronic incapacity to integrate security, political, economic, and administrative requirements in a central and long-term decision-making process."<sup>47</sup>

### Regulatory Quality

Pakistan's performance (see Fig. 7) in improving regulatory quality has been somewhat better than its efforts in other governance areas. Starting from a low of the 18th percentile in 2004, the country had increased its score to the 33rd percentile by 2009 (albeit down from 39th in 2006). This score was still somewhat below the Asian average of the 50th percentile and India's 44th percentile.

Burki notes that, even though Pakistan has done relatively well in improving regulatory quality in recent years, Pakistan's regulatory system remains seriously underdeveloped for a country of its size. He argues that this situation stems from the fact that regulation in Pakistan has evolved more in response to special interests rather than to citizen needs and demands. While this pattern may change with the devolution of authority to the provinces, Burki cautions that the weaknesses in the existing regulatory system could complicate efforts to distinguish between functions that can

45. Aftab, "Democracy, Three Years Later," *The Friday Times*, April 1, 2011.

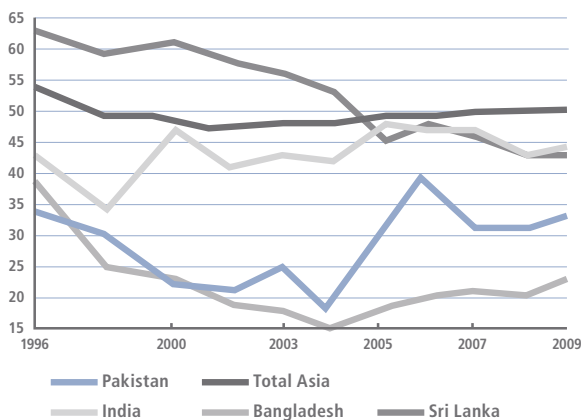
46. Stephen Cohen, "Keeping Pakistan From Falling Apart," *World Politics Review* (May 2011): 1.

47. Ibid.

only be performed at the federal level and those that can be more efficiently handled locally.<sup>48</sup>

Nadeem ul Haque cites regulatory quality as key to improving Pakistan's productivity. Ul Haque notes that state enterprises like PIA, Pakistan Railways, and power sector organizations could improve productivity significantly, and thus contribute to national economic growth, through regulatory reforms.<sup>49</sup>

Fig. 7. Regulatory Quality



Source: World Bank, *Worldwide Governance Indicators*, <http://info.worldbank.org/governance/wgi/index.asp>.

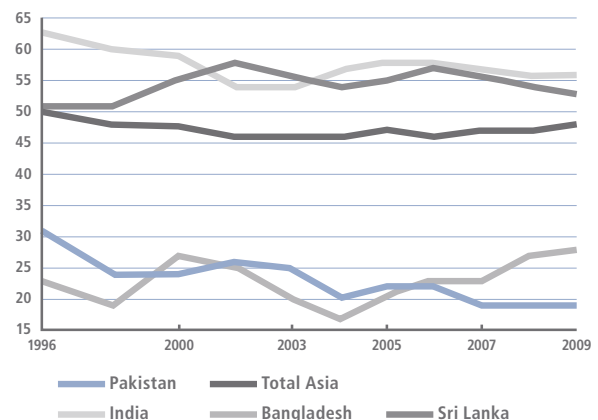
### Rule of Law

In the critical area of rule of law, Pakistan again falls short of other South Asian countries (see Fig. 8). The country ranked in the 31st percentile in 1996, declined to the 20th percentile in 2004, improved slightly to the 22nd percentile, then dipped to the 19th percentile by 2009. In 2009, the average for Asian countries as a whole was the 48th percentile, with India ranking in the 56th, and Sri Lanka the 53rd. Between 2004 and 2009, Bangladesh was able to increase its ranking from the 17th to the 28th percentile.

A study by the Asian Society highlights the importance of Pakistan's improving its rule of

law. The Asia Society's Pakistan 2020 Study Group concluded that seven core issues needed to be addressed to ensure a sound future for the country by 2020. The recommendations included (1) strengthening democratic institutions, (2) strengthening the rule of law, (3) improving human development and social services, especially in health and education, (4) developing the energy infrastructure, (5) assisting the victims of the 2010 flood in their

Fig. 8. Rule of Law



Source: World Bank, *Worldwide Governance Indicators*, <http://info.worldbank.org/governance/wgi/index.asp>.

recovery, (6) improving internal security, and (7) advancing the peace process with India.<sup>50</sup>

### Control of Corruption

Corruption, the final World Bank measurement of governance, has followed an erratic pattern in Pakistan during the past two decades (see Fig. 9). Starting in the 7th percentile in 1996, Pakistan gradually improved its score to the 30th percentile in 2003, declined again to the 14th and 15th percentiles in 2004 and 2005 respectively, and rose to the 26th percentile in 2007. Since then the country's ranking has fallen (2009) to the 13th percentile, the lowest rank among the South Asian countries. For reference, the Asian average in 2009

48. Burki, "Devolution and Regulatory Changes," *Dawn*, April 25, 2011.

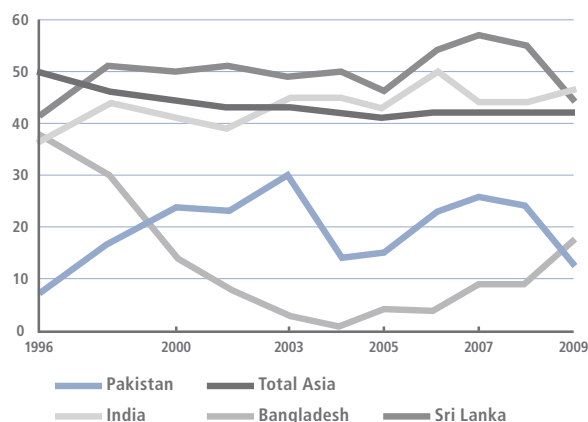
49. "Nadeem-ul-Haq Links High Growth Rate to Economic Reforms," *Associated Press of Pakistan*, July 6, 2011.

50. Hassan Abbas, *Pakistan 2020: A Vision for Building a Better Future*, *Asia Society Pakistan Study Group Report*, May 2011.

was the 42nd percentile with India slightly higher at the 47th percentile. Ominously, the perception of corruption in Pakistan is worsening, with the police, land administration institutions, the judiciary, education, and local governments regarded as the most corrupt public-sector institutions.<sup>51</sup>

As shown in Fig. 5, businesses cite corruption as their major concern in doing business in Pakistan. Furthermore, according to Transparency International’s 2009 report, corruption prevents the “poor from participating equally in political decisions, from enjoying equality under the law, from seeing their needs reflected in policies and budgets and from accessing public goods and services ... Decisions on food and energy security, natural resources, technology and investments are often compromised by corruption—with fatal consequences.”<sup>52</sup> Significantly, the government of Pakistan has barred Transparency International from conducting surveys in the country for the organization’s next annual report.<sup>53</sup>

Fig. 9. Control of Corruption



Source: World Bank, *Worldwide Governance Indicators*, <http://info.worldbank.org/governance/wgi/index.asp>.

## Potential Economic Reform Constraints

In addition to arguments linking poor growth and development, instability, and even terrorism to governance failures, an equally valid claim can be made that these processes stem from a poor country record in economic reforms and associated progress toward economic freedom. Jennifer Bremer and John Kasarda’s terrorism and economic transitions model suggests that failure to enact needed economic reforms can result in inefficiencies and a lack of incentives for entrepreneurship while preventing more dynamic growth patterns. The resulting economic malaise spurs a vicious circle of instability, low investment, low growth, and further widespread discontent.<sup>54</sup>

Bremer and Kasarda view transition as occurring in three phases (see Fig. 10). The first phase typically begins when a low-income country rapidly begins to industrialize, launching an agrarian-industrial transition and the complex transformations in urbanization, income growth, and economic diversification that accompany it. A process similar but not identical to Rostow’s<sup>55</sup> takeoff occurs. If growth is sustained for a decade or more, the country may reach the second transition phase, in which industrial production per capita can increase as much as threefold, growth in low-value-added manufacturing is rapid and sustained, and rising incomes lead to the emergence of a middle class. Assuming this middle phase is successful, the country will likely reach the advanced phase in ten to twenty years. Countries that are currently in the advanced phase include Brazil, Poland, Russia, and Turkey.<sup>56</sup>

In contrast, Pakistan remains stalled in the first stage of this model, along with countries

51. Heritage Foundation, *Economic Opportunity and Prosperity: The 2011 Index of Economic Freedom* (Washington, D.C.: Heritage Foundation, 2011).

52. Transparency International, *Transparency International Corruption Perceptions Index*, (Berlin: Transparency International, 2009).

53. Siddiqi Hammad, “No Corruption Survey in Pakistan This Year,” *Center for International Private Enterprise Development Blog*, July 7, 2011, <http://www.cipe.org/blog/?p=8649>.

54. Jennifer Bremer and John Kasarda, “The Origins of Terror: Implications for U.S. Foreign Policy,” *Milken Institute Review* (Fourth Quarter 2002): 34–48.

55. W.W. Rostow, *The Stages of Economic Growth: A Non-Communist Manifesto* (Cambridge: Cambridge University Press, 1960).

56. Bremer and Kasarda, “The Origins of Terror.”

like Egypt, Iran, and Saudi Arabia. According to Bremer and Kasarda, these countries are trapped in this stage due to their failure to adopt choice-based systems encompassing both market-based economic reforms and democratic political institutions and organizations. Without the adoption and proper sequencing of such reforms, they cannot progress up the ladder to more sophisticated production structures and, as a result, will face rising popular discontent and instability, along with the threat of terrorist insurrection.<sup>57</sup>

### Limited Progress in Economic Freedom

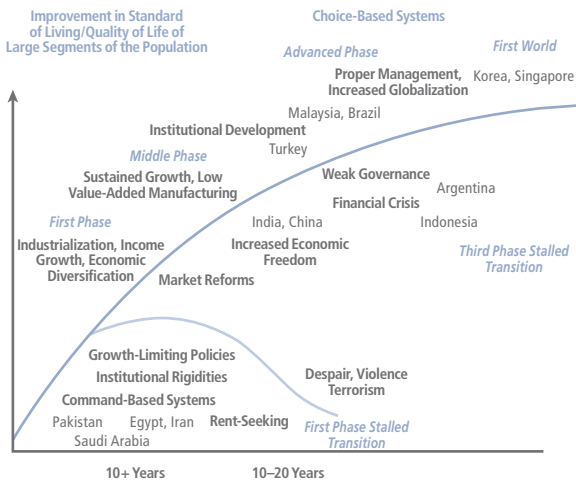
No indices of the prevalence of choice-based systems exist. However, the Fraser Institute's Economic Freedom of the World<sup>58</sup> and the Heritage Foundation and *The Wall Street Journal's* Index of Economic Freedom<sup>59</sup> are good proxies in that they measure the relative progress of countries in moving toward a deregulated, limited government, free-market environment. The Heritage Foundation

dataset was chosen for this study because it contains a larger sample of countries.

To measure economic freedom, the Heritage Index takes ten different factors into account: (1) trade policy, (2) fiscal burden of government, (3) government intervention in the economy, (4) monetary policy, (5) banking and finance, (6) capital flows and foreign investment, (7) wage and prices, (8) property rights, (9) regulation, and (10) the informal market. These factors are designed to measure the openness of countries to competition, the degree of state intervention in the economy, and the ability of the courts to enforce rules and property rights. The Heritage Foundation emphasizes that countries must score well in all ten of the factors in order to improve their economic efficiency and, consequently, the living standards of their people.<sup>60</sup>

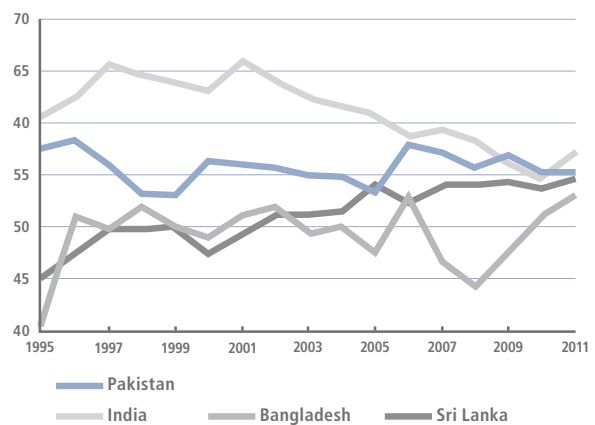
In the 2011 Heritage Foundation Index of Economic Freedom, Pakistan's score was 55.1, compared to highest-ranking Hong Kong at 89.7. Pakistan ranked twenty-fourth of forty-one countries in the Asia-Pacific region, with an overall score that was below both the

Fig. 10. Transitions and Institutional Constraints



Source: Robert Looney, "Failed Economic Take-Offs and Terrorism in Pakistan," *Asian Survey* (November/December 2004).

Fig. 11. Overall Economic Freedom Score



Source: Heritage Foundation, *Index of Economic Freedom* database, 2011.

57. Ibid.

58. Gwartney, et al., *Economic Freedom of the World 2010 Annual Report*.

59. Heritage Foundation, *The 2011 Index of Economic Freedom*.

60. Ibid.

world and regional averages. While Pakistan's aggregate Economic Freedom ranking compared relatively favorably to those of Bangladesh, Sri Lanka, and India (see Fig. 11), the country made few gains in the overall liberalization of the economy, as indicated by the fact that its score in 2011 was slightly lower than in 1995.<sup>61</sup>

On the positive side, Pakistan has pursued reforms to improve its entrepreneurial environment and facilitate private-sector development. In addition, the country made significant gains in recent years in liberalizing restrictions on trade (see Fig. 12), although its progress in this area lagged behind India's by a wide margin. However, in other areas, Pakistan's progress lags considerably. Its tax system is complex and inefficient, though reforms have been undertaken to cut tax rates, broaden the tax base, and increase transparency. The judicial system suffers from a serious backlog and poor security, and corruption taints both the judiciary and civil service. In addition, restrictions on foreign investment and state involvement in the economy are serious drags on economic dynamism.<sup>62</sup>

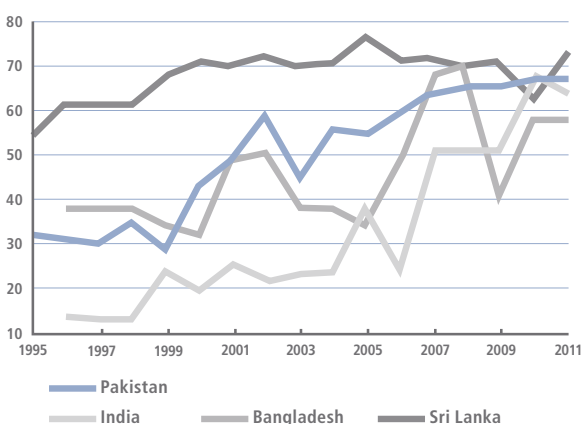
An examination of the group means by World Economic Forum groupings (Tables 3 and 4) shows a pattern similar to that found in the governance dimensions: countries show steady progress in

economic reforms as they move from Group 1 to Group 5. The one major exception is in the fiscal area, where lower levels of government spending and taxes are considered freer. Given the expansion of government spending in the advanced countries, Groups 4 and 5 score low on this dimension.

In contrast with the governance indicators, Pakistan compares slightly favorably with other Group 1 countries. Overall, it scored 55.1 versus 54.3 for Group 1 countries. For Business Freedom it scored 70.9 versus 55.5; for Fiscal Freedom, 80.5 versus 77.1; and for Government Spending, 88.8 versus 75.2. It should be noted, however, that the Heritage Foundation considers low government spending and minimal tax rates as a sign of economic freedom. While many would agree that this measure makes sense for developed economies, critics of Pakistan's economic management contend it is precisely these attributes that have created the country's current crisis of growing income inequality, crumbling infrastructure, and an educational system incapable of meeting the needs of a modern economy.

On the negative side, Pakistan scores below the Group 1 norm in the areas of Trade Freedom (67.0 versus 69.5 for Group 1 countries), Monetary Freedom (63.6 versus 70.0), Investment Freedom (40.0 versus 41.2), Financial Freedom (40.0 versus 43.3), Property Freedom (30.0 versus 30.2), Freedom from Corruption (24.0 versus 27.0), and Labor Freedom (46.3 versus 57.6).

Fig. 12. Trade Freedom



Source: Heritage Foundation, *Index of Economic Freedom* database, 2011.

## Deficiencies in Entrepreneurial Access to Capital

The Milken Institute's Capital Access Index (CAI) provides an additional perspective on Pakistan's progress in supporting entrepreneurship and a modern economy. This index scores the ability of entrepreneurs to gain access to financial capital in countries around the world. The CAI measures not only the breadth, depth, and vitality of capital markets, but also openness in providing access

61. Ibid.

62. Ibid.

## Deficiencies in Entrepreneurial Access to Capital

Table 3. Group Means on Economic Freedom Dimensions I, World Economic Forum Development Stages, 2010–2011

	World Economic Forum Stages	Overall Freedom Score	Business Freedom	Trade Freedom	Fiscal Freedom	Government Spending	Monetary Freedom
1	Mean	54.300	55.460	69.537	77.051	75.168	69.886
	Number of Countries	38	38	38	37	37	37
	Std. Deviation	5.867	11.605	7.503	9.418	15.816	5.591
	<b>Pakistan</b>	<b>55.2</b>	<b>71.7</b>	<b>67.0</b>	<b>80.5</b>	<b>88.8</b>	<b>69.4</b>
2	Mean	57.260	65.150	74.792	82.204	71.667	66.329
	Number of Countries	24	24	24	24	24	24
	Std. Deviation	9.639	16.136	10.320	11.229	15.905	7.024
3	Mean	61.890	67.110	78.090	80.517	71.893	71.928
	Number of Countries	29	29	29	29	29	29
	Std. Deviation	6.263	9.410	7.970	7.884	16.450	4.942
4	Mean	68.910	72.550	84.136	80.693	63.229	72.879
	Number of Countries	14	14	14	14	14	14
	Std. Deviation	4.936	9.822	7.166	9.408	17.512	4.184
5	Mean	73.190	85.470	86.391	64.234	49.128	78.613
	Number of Countries	32	32	32	32	32	32
	Std. Deviation	6.899	10.272	3.562	14.439	19.451	3.810
Total	Mean	62.330	68.380	77.696	76.059	66.496	72.055
	Number of Countries	137	137	137	138	136	138
	Std. Deviation	10.057	15.860	9.818	12.693	19.661	6.649

Source: Heritage Foundation, *Index of Economic Freedom* database, 2010.

Table 4. Group Means on Economic Freedom Dimensions II, World Economic Forum Development Stages, 2010–2011

	World Economic Forum Stages	Investment Freedom	Financial Freedom	Property Rights	Freedom from Corruption	Labor Freedom
1	Mean	54.300	55.460	69.537	77.051	75.168
	Number of Countries	38	38	38	37	37
	Std. Deviation	5.867	11.605	7.503	9.418	15.816
	<b>Pakistan</b>	<b>55.2</b>	<b>71.7</b>	<b>67.0</b>	<b>80.5</b>	<b>88.8</b>
2	Mean	57.260	65.150	74.792	82.204	71.667
	Number of Countries	24	24	24	24	24
	Std. Deviation	9.639	16.136	10.320	11.229	15.905
3	Mean	61.890	67.110	78.090	80.517	71.893
	Number of Countries	29	29	29	29	29
	Std. Deviation	6.263	9.410	7.970	7.884	16.450
4	Mean	68.910	72.550	84.136	80.693	63.229
	Number of Countries	14	14	14	14	14
	Std. Deviation	4.936	9.822	7.166	9.408	17.512
5	Mean	73.190	85.470	86.391	64.234	49.128
	Number of Countries	32	32	32	32	32
	Std. Deviation	6.899	10.272	3.562	14.439	19.451
Total	Mean	62.330	68.380	77.696	76.059	66.496
	Number of Countries	137	137	137	138	136
	Std. Deviation	10.057	15.860	9.818	12.693	19.661

Source: Heritage Foundation, *Index of Economic Freedom* database, 2010.



without discrimination, a measure of global progress in the democratization of capital.

The seven components of the CAI are:

- *Macroeconomic environment*: the favorableness of conditions for running and financing a business, based on such variables as inflation, interest rates, tax rates, and financial sophistication relative to international norms;
- *Institutional environment*: the extent to which institutions support and enhance business financing activities, based on variables that include the enforceability of property rights, the impartiality of the judicial system, the efficiency of bankruptcy procedures, and the levels of corruption;
- *Financial and banking institutions*: the involvement of deposit-taking institutions in financing businesses, based on such variables as the extension of credit to the private sector, the soundness of financial institutions, the ease of access to bank loans, and the efficiency of the banking system;
- *Equity market development*: the importance of equity financing of business operations, based on such variables as stock market capitalization relative to GDP, stock market liquidity, and changes in the number of listings;
- *Bond market development*: the importance of bond financing for businesses, based on variables such as the value of private and public bonds relative to GDP and securitized asset issuance relative to GDP;
- *Alternative sources of capital*: the level of usage of diverse financing sources, such as venture capital, credit cards, and nonpublic stock offerings or other private placements; and
- *International funding*: the availability of foreign capital to businesses in a particular country, based on such variables as the volatility of exchange rates, international reserve holdings,

portfolio and foreign direct investment, capital inflows and outflows, and sovereign ratings.

According to the 2009 CAI, Pakistan ranked seventy-fourth out of 122 countries with a score of 3.93. In contrast, India ranked forty-fourth, with a score of 5.51, Sri Lanka ranked seventy-second, and Bangladesh ranked eighty-fifth. While Pakistan showed some progress from 2002 to 2006, its scores have since been in decline, whereas India has had a fairly dramatic increase over time in this key measure (see Fig. 13). Pakistan did, however, make relatively good progress in several of the Capital Access subcomponents (Table 5), including equity market development (ranked fortieth) and bond market development (ranked forty-fifth). On the other hand, the country was considerably behind in macroeconomic environment (ranked 110th) and international funding (ranked ninety-third).

In sum, the progress made by Pakistan in the critical areas of competitiveness, governance, economic reform, and capital access remains disappointing, with retrogressions occurring in several key areas. Even during periods of rapid growth, the country was unable to make significant gains.

If the models of economic stagnation and terrorism developed by Bremer and Kasarda play out along expected lines, the country's future is dire. The situation has been best summed up by long-time *Financial Times* columnist Farhan Bokhari. Observing the country's ever-shifting political alliances and infighting, he notes that such developments:

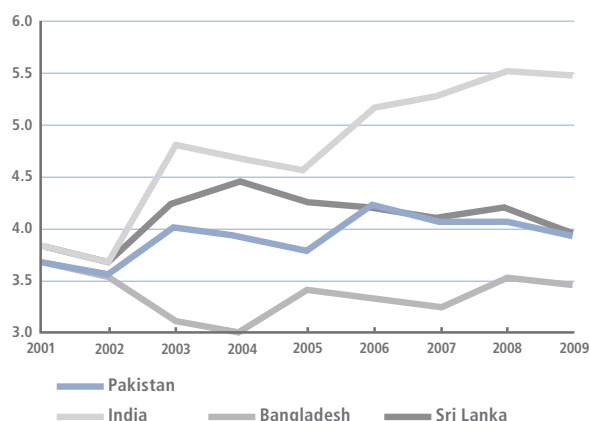
*...only work to reinforce the largely tainted view of Pakistan's prevailing political order, built to protect and promote the country's vested interests across its urban and rural belts. Pakistan's survival, prosperity and stability depend fundamentally on the ability of its ruling class to reform the country on multiple fronts. Without giving a new direction to Pakistan's economy backed by reforms surrounding internal management and governance, the country's outlook will largely remain unchanged.<sup>63</sup>*

63. Farhan Bokhari, "Pakistan Stability Hinges on Reform," *gulfnews.com*, April 24, 2011.



If the country is to move ahead, where should the emphasis lie in developing a reform strategy

Fig. 13. Progress in Entrepreneurial Access to Capital



Source: The Milken Institute, Capital Access Index, 2010.

to overcome the impediments posed by the country's governance/institutional structures? The next section addresses this issue through the development of an empirically based model structured to identify the nature and sequencing of the most urgent reforms.

## Constraints on Pakistan's Growth Potential and Entrepreneurship

It is unrealistic to expect that the Pakistani government, or any government for that matter, could address all the potential constraints identified in the previous section. Hausmann, Rodrik, and Velasco suggest that a better approach is

Table 5. Financial Sector Development

<b>Capital Access Index: Summary</b>	<b>Rank</b>	<b>Score</b>	<b>Equity Market Development</b>	<b>Rank</b>	<b>Score</b>
Pakistan	74	3.93	Pakistan	40	5.17
India	44	5.51	India	14	6.50
Sri Lanka	72	3.96	Sri Lanka	40	5.17
Bangladesh	85	3.48	Bangladesh	33	5.50
<b>Macroeconomic Environment</b>			<b>Bond Market Development</b>		
Pakistan	110	3.75	Pakistan	45	4.25
India	63	5.83	India	33	5.25
Sri Lanka	113	3.50	Sri Lanka	76	2.50
Bangladesh	99	4.17	Bangladesh	62	3.50
<b>Institutional Environment</b>			<b>Alternative Sources of Capital</b>		
Pakistan	70	4.82	Pakistan	74	1.75
India	71	4.76	India	18	6.25
Sri Lanka	56	5.35	Sri Lanka	72	2.00
Bangladesh	110	3.24	Bangladesh	86	0.75
<b>Financial and Banking Institutions</b>			<b>International Funding</b>		
Pakistan	72	3.90	Pakistan	93	2.75
India	46	5.10	India	25	5.50
Sri Lanka	62	4.40	Sri Lanka	76	3.42
Bangladesh	69	4.00	Bangladesh	97	2.50

Source: Compiled from: James R. Barth, Tong Li, Wenling Lu, and Glen Yago, *Capital Access Index 2009: Best Markets for Business Access to Capital* (Santa Monica, CA: Milken Institute, April 2010).

## Constraints on Pakistan's Growth Potential and Entrepreneurship

to identify and address the one or two most binding present constraints. To this end, they propose that each country use a decision tree methodology (see Fig. 14) to identify binding constraints and policy options. Their framework focuses on the short term, identifying constraints as they emerge rather than attempting to anticipate future impediments to growth.<sup>64</sup>

While this approach provides a good starting point, the goal of the present study is to develop a model that addresses both entrepreneurship and growth, which are unlikely to face the same constraints simultaneously. Furthermore, given Pakistan's history of stalled growth and failed takeoffs, it is crucial to identify the correct sequence of reforms necessary to firmly set the country on the path to development and keep it there. It is hoped that the model that emerges can

offer direction, not only to Pakistan, but to broad classes of countries facing similar circumstances.

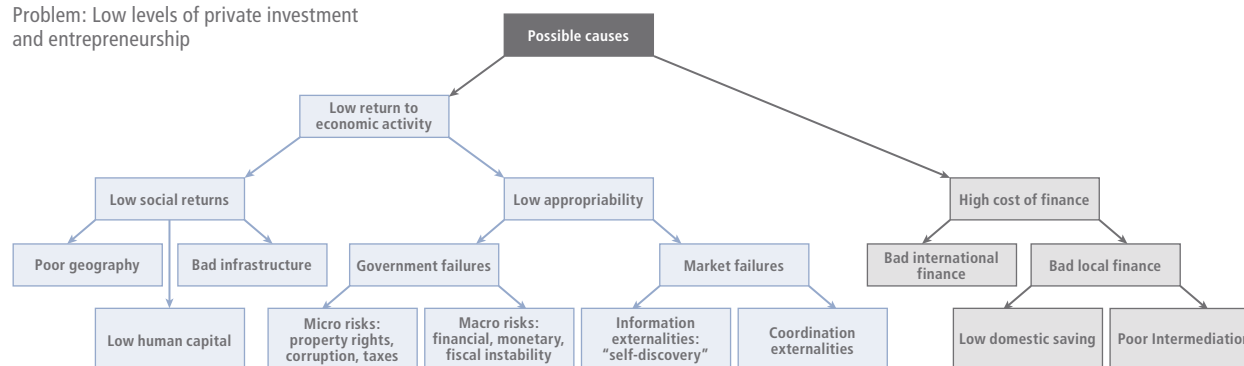
As the basis for the model, the World Economic Forum Competitiveness Indicators (WEF), the World Bank Governance Indicators (WB), and the Heritage Foundation Index of Economic Freedom (EF) were merged into a single database.<sup>65</sup> Added to this were the World Bank's database on entrepreneurial activity<sup>66</sup> and the size of the shadow economy (percent of GDP) in individual countries.<sup>67</sup> The shadow economy is relatively large in Pakistan, averaging around 37.1 percent of GDP.<sup>68</sup> It is included in part to track the country's movement toward an efficient competitive economy, since the literature on entrepreneurship and growth stresses the necessity of transforming informal/shadow activities into formal entities with higher productivity and taxpaying potential.<sup>69</sup>

Fig. 14. Growth Constraint Decision Tree

### Time for a checkup

A decision tree, such as the one below, can help identify the biggest obstacles to growth.

Problem: Low levels of private investment and entrepreneurship



Source: Ricardo Hausmann, Dani Rodrik, and Andres Velasco, "Getting the Diagnosis Right," *Finance and Development* (March 2006).

64. Ricardo Hausmann, Dani Rodrick, and Andres Velasco, "Getting the Diagnosis Right: A New Approach to Economic Reform," *Finance & Development* (March 2006).

65. Preliminary analysis suggested that, while the Milken Institute Capital Access dataset provided some interesting insights to the Pakistani situation, because of its relatively narrow focus it did not contribute a significant amount of information over and above that provided by the other three datasets.

66. World Bank, Enterprise Snapshots (WBGES), 2010, which comprises the number of newly registered limited liability companies per 1,000 working-age people (ages 15–64).

67. Data compiled in Friedrich Schneider and Andreas Buehn, "Shadow Economics and Corruption All Over the World: Revised Estimates for 120 Countries," *Economics: the Open Access, Open-Assessment E-Journal* (October 27, 2009).

68. Ibid.

69. Friedrich Schneider with Dominik Enste, *Hiding in the Shadows: The Growth of the Underground Economy* (Washington, D.C.: International Monetary Fund, 2002).

## Key Dimensions of Growth Potential and Entrepreneurship

The first step in the analysis was to assess the main trends in the data, as well as to confirm the profile of Pakistan's development situation that we have seen thus far. The key questions examined were:

1. Of the twenty-eight potential constraints on growth contained in the merged database, how many distinct phenomena are represented?
2. Do the same elements impact increased entrepreneurship and growth potential, or is each linked to a separate set of conditions?
3. What is Pakistan's relative attainment on these key dimensions?

To answer these questions, a factor analysis was undertaken for the total sample of country groupings (Groups 1-5), as well as for sequential subsets of country groupings through the five stages of development.<sup>70</sup>

The rotated factor matrix (Table 6) identified five main trends or dimensions in the combined data set for the total sample of countries. Factor 1 variables were loaded on a dimension associated with economic freedom; Factor 2 variables on fiscal freedom and state of governance; Factor 3 variables on health/education/trade; Factor 4 variables on labor efficiency/freedom and institutions; and Factor 5 variables on a competitiveness dimension.

In the total sample of countries, growth potential is most highly associated with several components of Factor 5, the competitiveness dimension, namely, the WEF's (a) market size, (b) macroeconomic environment, (c) business sophistication, and (d) infrastructure. However, a sharp picture does not emerge, as growth potential is also associated to a lesser extent with Factors 1-4.

Entrepreneurship does not seem to be highly associated with any of the main trends in the data.

Instead, this key variable is fairly equally associated with Factor 1 (economic freedom), Factor 3 (health/education), and Factor 4 (labor market freedom and efficiency). Although causation cannot be firmly established at this point, a safe assumption is that entrepreneurship is positively affected by improved economic freedom, better health/education, and progress in freeing labor markets, a key area in facilitating the establishment of new firms. The mean factor scores by WEF country groupings suggests development through the various stages is associated with steady improvements in governance (Factor 2), and to a lesser extent economic freedom (Factor 1), with a sizeable jump in governance occurring when countries transition from Group 4 to Group 5.

In terms of creating an environment for the growth of entrepreneurship, Pakistan scores slightly above Group 1 countries on economic freedom but has one of the lowest attainments on health/education and is below the group average in labor market development. The country appears to be well above the Group 1 mean for potential growth (Factor 5), a finding that may be due simply to the dominance of market size in contributing to this dimension.

It is likely that many of the key linkages between growth potential and entrepreneurship are blurred due to the great diversity of country environments. To sharpen the focus, a more detailed analysis was undertaken of the various country subgroupings. For our purposes, a key issue is that of facilitating Pakistan's movement up the development ladder. Do the factors impacting growth and entrepreneurial activity in these individual groupings differ from those for the total sample of countries, and if so, which are critical?

The biggest difference between the patterns for Group 1 and Group 2 countries and those of the total country sample is a sharpening in the area of growth potential. When the factor analysis is confined to Group 1 and Group 2 countries (Table 7), the growth potential term (Factor 1) is narrowly

70. See the classic work by Irma Adelman and Cynthia Taft Morris, "A Factor Analysis of the Interrelationship Between Social and Political Variables and Per Capita Gross National Product," *Quarterly Journal of Economics* (November 1965) for a discussion of the method and interpretation of results. See also their "Factor Analysis and Development," *Journal of Development Economics* (August 1982).

## Key Dimensions of Growth Potential and Entrepreneurship

Table 6. Factor Analysis: Growth Potential/Entrepreneurship Linkages— Total Sample of Countries (loadings on principal dimensions)

Key Indicators	Main Dimensions				
	Factor 1 Economic Freedom	Factor 2 Fiscal/ Governance	Factor 3 Health/ Education	Factor 4 Labor Market Efficiency	Factor 5 Growth/ Competitiveness
EF Investment Freedom	0.803	0.198	0.362	0.131	0.013
EF Financial Freedom	0.701	0.162	0.317	0.166	0.145
EF Monetary Freedom	0.725	0.240	0.026	0.067	0.301
EF Overall Economic Freedom Score	0.710	0.100	0.352	0.524	0.213
WB Regulatory Quality	0.662	0.382	0.438	0.313	0.284
WEF Financial Market Development	0.481	0.246	-0.024	0.443	0.473
EF Business Freedom	0.428	0.247	0.363	0.389	0.203
EF Fiscal Freedom	-0.211	-0.807	-0.017	0.118	-0.328
EF Government Spending	-0.075	-0.748	-0.382	0.118	0.082
WEF Innovation	0.223	0.613	0.176	0.387	0.545
WB Rule of Law	0.482	0.574	0.412	0.352	0.294
WB Voice and Accountability	0.537	0.570	0.448	-0.008	0.147
EF Property Rights	0.532	0.566	0.292	0.378	0.307
WB Control of Corruption	0.506	0.555	0.373	0.402	0.278
EF Freedom From Corruption	0.507	0.546	0.362	0.399	0.307
WEF Technological Readiness	0.440	0.512	0.471	0.295	0.403
WB Government Effectiveness	0.493	0.503	0.426	0.374	0.375
WEF Health and Primary Education	0.161	0.304	0.747	0.181	0.367
EF Trade Freedom	0.492	0.087	0.715	0.088	0.072
WEF Higher Education and Training	0.219	0.485	0.624	0.267	0.442
WB Political Stability	0.382	0.355	0.596	0.273	0.098
WEF Labor Market Efficiency	0.202	0.109	0.210	0.818	0.093
EF Labor Freedom	0.007	-0.195	0.043	0.759	-0.056
WEF Institutions	0.354	0.505	0.172	0.618	0.310
EF Goods Market Efficiency	0.495	0.356	0.183	0.580	0.416
<b>Entrepreneurship</b>	<b>0.395</b>	<b>0.136</b>	<b>0.423</b>	<b>0.455</b>	<b>-0.074</b>
WEF Market Size	-0.021	0.191	0.033	-0.160	0.812
WEF Macroeconomic Environment	0.353	-0.101	0.298	0.116	0.647
<b>Growth Potential</b>	<b>0.304</b>	<b>0.414</b>	<b>0.388</b>	<b>0.402</b>	<b>0.639</b>
WEF Business Sophistication	0.329	0.529	0.186	0.303	0.636
WEF Infrastructure	0.341	0.416	0.490	0.279	0.542

Notes: Extraction Method: IBM SPSS19.0 Principle Component Analysis. Rotation Method Variamax with Kaiser Normalization. Rotation converged in nine iterations. WEF = World Economic Forum Dataset; EF = Heritage Economic Freedom Dataset; WB = World Bank Governance Dataset. Entrepreneurship: World Bank, Enterprise Snapshots (WBGES) 2010.

### Country Factor Scores

<b>Pakistan</b>	<b>-0.323</b>	<b>-0.036</b>	<b>-2.532</b>	<b>-0.648</b>	<b>0.183</b>
<b>Difference: Pakistan – Group 1</b>	<b>0.122</b>	<b>0.060</b>	<b>-1.244</b>	<b>-0.580</b>	<b>0.948</b>

### Mean Factor Scores

Group 1 Countries	-0.445	-0.096	-1.288	-0.068	-0.765
Group 2 Countries	-0.741	-0.616	-0.022	-0.133	-0.013
Group 3 Countries	-0.148	-0.613	0.078	-0.234	0.132
Group 4 Countries	0.346	-0.254	0.882	-0.158	-0.256
Group 5 Countries	0.567	0.878	0.425	0.334	0.444

## Key Dimensions of Growth Potential and Entrepreneurship

Table 7. Factor Analysis: Growth Potential/Entrepreneurship Linkages—  
Country Groups 1 and 2 (loadings on principal dimensions)

Key Indicators	Main Dimensions							
	Factor 1 Growth Education	Factor 2 Governance	Factor 3 Competi- tiveness	Factor 4 Economic Freedom	Factor 5 Labor Freedom Efficiency	Factor 6 Democracy	Factor 7 Macro- Economic Stability	Factor 8 Political Stability
WEF Health and Primary Education	0.899	0.065	-0.041	0.000	-0.124	0.171	-0.122	0.093
WEF Higher Education and Training	0.896	-0.131	0.167	-0.058	0.025	-0.269	-0.019	0.022
EF Infrastructure	0.879	0.222	0.221	0.097	-0.046	0.008	0.019	-0.105
<b>Growth Potential</b>	<b>0.796</b>	<b>0.195</b>	<b>0.454</b>	<b>-0.105</b>	<b>0.032</b>	<b>0.163</b>	<b>0.210</b>	<b>0.083</b>
WEF Technological Readiness	0.651	0.115	0.497	0.163	0.126	-0.171	0.261	-0.103
EF Trade Freedom	0.594	-0.311	-0.357	0.300	0.096	-0.138	0.151	0.214
WB Control of Corruption	0.019	0.920	-0.006	0.147	-0.081	-0.019	0.004	0.040
WB Rule of Law	0.132	0.819	0.216	0.154	-0.015	-0.124	-0.006	0.114
EF Freedom from Corruption	-0.069	0.808	-0.074	0.203	-0.209	-0.255	0.136	-0.196
WB Government Effectiveness	0.391	0.700	0.190	0.377	0.050	0.013	-0.026	0.073
WEF Institutions	-0.025	0.681	0.251	-0.185	0.389	0.338	-0.132	0.201
EF Property Rights	-0.092	0.660	0.336	0.272	-0.084	-0.274	-0.164	0.019
WEF Business Sophistication	0.349	0.051	0.879	-0.060	-0.154	0.038	0.052	-0.084
WEF Financial Market Development	0.044	0.055	0.875	0.231	0.065	-0.099	-0.120	0.012
WEF Innovation	0.065	0.284	0.767	-0.345	-0.049	0.034	0.138	0.111
WEF Goods Market Efficiency	0.103	0.393	0.724	0.178	0.218	0.187	-0.041	-0.031
WEF Market Size	0.296	-0.117	0.561	-0.243	-0.318	-0.068	0.194	-0.270
EF Fiscal Freedom	0.076	-0.448	-0.480	0.286	0.088	0.193	-0.354	0.117
EF Financial Freedom	0.035	0.082	-0.101	0.890	-0.045	-0.105	-0.007	0.162
EF Overall Freedom Score	0.044	0.172	-0.106	0.870	0.310	0.222	0.052	-0.132
EF Investment Freedom	-0.082	0.184	0.002	0.853	0.093	0.052	0.003	0.042
WB Regulatory Quality	0.229	0.312	0.238	0.802	0.140	-0.142	-0.005	0.018
EF Labor Freedom	-0.006	-0.097	0.010	0.150	0.849	0.018	-0.110	-0.156
WEF Labor Market Efficiency	-0.089	-0.072	0.007	0.105	0.834	0.013	-0.034	0.393
<b>Entrepreneurship</b>	<b>0.474</b>	<b>-0.067</b>	<b>-0.273</b>	<b>0.445</b>	<b>0.522</b>	<b>-0.179</b>	<b>0.173</b>	<b>-0.116</b>
EF Government Spending	-0.075	-0.216	0.216	0.232	-0.186	0.779	0.196	-0.057
WB Voice and Accountability	0.049	0.242	0.305	0.269	-0.283	-0.705	-0.045	0.147
WEF Macroeconomic Environment	0.309	-0.102	0.046	-0.077	-0.060	0.267	0.828	0.148
EF Monetary Freedom	-0.412	0.086	0.074	0.467	-0.171	-0.035	0.628	-0.089
WB Political Freedom	0.249	0.300	-0.273	0.252	0.199	-0.155	0.160	0.590
EF Business Freedom	0.258	0.270	-0.374	0.362	0.349	0.295	0.015	-0.482

Notes: Extraction Method: IBM SPSS 19.0 Principle Component Analysis. Rotation Method Variamax with Kaiser Normalization. Rotation converged in fifteen iterations. WEF = World Economic Forum Dataset; EF = Heritage Economic Freedom Dataset; WB = World Bank Governance Dataset. Entrepreneurship: World Bank Enterprise Snapshots (WBGES) 2010.

### Factor Scores

<b>Pakistan</b>	<b>-0.912</b>	-0.863	0.658	<b>-0.301</b>	<b>-0.916</b>	0.675	-0.780	-2.520
<b>Difference: Pakistan - Group 1</b>	<b>-0.307</b>	-0.740	0.717	<b>-0.159</b>	<b>-0.850</b>	0.748	-0.655	-2.627

### Mean Factor Scores

Group 1 Countries	<b>-0.605</b>	-0.123	-0.059	<b>-0.142</b>	<b>-0.066</b>	-0.073	-0.125	0.107
Group 2 Countries	<b>0.907</b>	0.185	0.089	<b>0.212</b>	<b>0.099</b>	0.109	0.187	-0.160
Difference: Group 2 - Group 1	<b>1.512</b>	0.308	0.148	<b>0.354</b>	<b>0.165</b>	0.182	0.312	-0.267

## Key Dimensions of Growth Potential and Entrepreneurship

Table 8. Factor Analysis: Entrepreneurship Linkages—Country Groups 2 and 3 (loadings on principal dimensions)

Key Indicators	Main Dimensions						
	Factor 1 Institutions/ Competitiveness	Factor 2 Economic Freedom Governance	Factor 3 Democracy Political Stability	Factor 4 Labor Efficiency/ Freedom	Factor 5 Health Education	Factor 6 Macro- Economic Stability	Factor 7 Government Spending
WB Government Effectiveness	0.864	0.025	0.136	0.069	0.088	0.009	-0.044
EF Property Rights	0.837	0.239	0.105	-0.115	0.002	-0.189	0.100
WEF Institutions	0.807	0.133	-0.225	0.117	0.248	0.192	-0.125
<b>Growth Potential</b>	<b>0.804</b>	<b>-0.356</b>	<b>-0.069</b>	<b>0.131</b>	<b>0.054</b>	<b>0.384</b>	<b>0.147</b>
WEF Goods Market Efficiency	0.802	0.231	0.005	0.221	0.072	0.187	0.225
WEF Business Sophistication	0.801	-0.273	0.080	-0.155	-0.171	0.162	0.252
WB Rule of Law	0.787	0.163	0.187	-0.008	0.351	-0.049	-0.250
WEF Financial Markets Development	0.764	0.123	0.174	0.103	-0.410	0.179	0.066
EF Freedom From Corruption	0.762	0.347	0.268	-0.200	0.204	-0.091	-0.078
WEF Infrastructure	0.718	-0.238	-0.175	0.096	-0.114	0.022	0.154
WEF Innovation	0.702	-0.613	-0.041	0.018	0.017	0.194	-0.082
WB Control of Corruption	0.693	0.370	0.360	-0.251	0.268	-0.123	-0.173
WEF Technological Readiness	0.566	-0.119	0.449	0.053	-0.048	0.378	-0.247
EF Investment Freedom	-0.034	0.837	0.316	-0.117	0.003	-0.028	-0.028
EF Overall Economic Freedom	0.390	0.827	0.166	0.203	0.083	0.022	0.233
EF Financial Freedom	0.206	0.746	0.250	0.153	-0.225	-0.045	0.168
EF Business Freedom	0.295	0.666	-0.337	0.182	-0.065	0.086	-0.142
WEF Market Size	0.081	-0.610	-0.023	-0.349	-0.232	-0.039	0.289
WEF Higher Education and Training	0.424	-0.610	0.162	0.243	0.284	0.092	-0.334
WB Regulatory Quality	0.544	0.609	0.425	0.194	-0.047	-0.051	0.040
EF Monetary Freedom	0.142	0.562	0.077	-0.256	0.055	0.435	0.030
WB Voice and Accountability	0.130	0.166	0.840	-0.072	-0.148	-0.101	-0.150
<b>Entrepreneurship</b>	<b>0.187</b>	<b>0.140</b>	<b>0.602</b>	<b>0.202</b>	<b>0.470</b>	<b>0.029</b>	<b>-0.070</b>
EF Trade Freedom	-0.228	0.421	0.598	0.289	0.143	-0.027	0.349
WB Political Stability	0.143	0.069	0.509	0.160	0.239	0.426	-0.304
WEF Labor Market Efficiency	0.059	-0.014	0.182	0.889	0.079	0.126	0.059
EF Labor Freedom	0.071	0.169	-0.065	0.836	0.164	-0.147	-0.182
WEF Health and Primary Education	0.224	-0.291	-0.013	0.152	0.718	0.022	-0.103
EF Fiscal Freedom	-0.206	0.426	0.156	0.401	0.582	0.025	0.204
WEF Macroeconomic Environment	0.095	0.006	-0.068	0.002	-0.024	0.864	0.189
EF Government Spending	0.261	0.135	-0.208	-0.101	-0.057	0.240	0.736

Notes: Extraction Method: IBM SPSS 19.0 Principle Component Analysis. Rotation Method Variamax with Kaiser Normalization. Rotation converged in eighteen iterations. WEF = World Economic Forum Dataset; EF = Heritage Economic Freedom Dataset; WB = World Bank Governance Dataset. Entrepreneurship: World Bank Enterprise Snapshots (WBGES) 2010.

### Mean Factor Scores

Group 2 Countries	-0.453	-0.089	<b>-0.666</b>	0.150	<b>-0.079</b>	-0.303	0.243
Group 3 Countries	0.226	0.011	<b>0.333</b>	-0.075	<b>0.040</b>	0.151	-0.121
Difference: Group 3 - Group 2	0.679	0.133	<b>0.999</b>	-0.225	<b>0.119</b>	0.454	-0.364

associated with health and primary education, followed by higher education and training and then infrastructure. In terms of economic freedom, openness to trade is also an important element contributing to a country's growth potential at this stage of development. Several elements of competitiveness reflected by Factor 3—business sophistication, financial market development, and innovation—are important to a lesser extent.

In Factor 1, the elements that contribute to expanded growth potential, Pakistan is considerably below the Group 1 norm. While it surpasses even Group 2 countries on the competitiveness elements of Factor 3, this advantage may be due to the country-size component of this factor. The significant difference in the means of Group 1 and Group 2 for Factor 1 suggests that forces in addition to increased per-capita income<sup>71</sup> are instrumental in allowing countries to make this transition.

As in the case of the total country sample, the factors determining entrepreneurship for Groups 1 and 2 are more diffuse and less focused. Factor 1, education/health, was a main contributor to the expansion of new firms, just as it was to growth potential. Also important were Factor 4, economic freedom, and Factor 5, improved labor market efficiencies and freedom. Pakistan scores poorly on each of these elements, especially education/health and the development of labor markets, suggesting that improvements in health and in all levels of education are critical for increased growth.

While Pakistan's immediate focus must be on accomplishing the transition to Group 2, it should also anticipate the challenges involved in transitioning to the higher groups. Toward this end, a factor analysis of WEF country Groups 2 and 3 was undertaken that produced several interesting pattern shifts (Table 8).

Replacing Group 1 countries with Group 3 countries in the sample shows that country growth potential is increasingly influenced by several components of governance and economic freedom. Growth potential loads heavily on

Factor 1, institutions and competitiveness. While competitiveness elements such as business sophistication and financial market development play an important role, so also do the World Bank's government effectiveness, rule of law, and control of corruption. Similarly, the Heritage Foundation measures of property rights and freedom from corruption now figure importantly in contributing to improved growth potential.

The factors associated with entrepreneurship also shift. For the Group 2 and 3 countries, entrepreneurship loads heaviest on Factor 3, democracy/political stability, with trade freedom also sharing a strong association with increased entrepreneurial activity. While health and education (Factor 5) remain important, they become secondary to institutional development as countries move up the development ladder.

For Groups 1 and 2, the seven factors (Table 7) show the largest differences in Factors 1 and 3, which are associated with growth and entrepreneurship. This result implies that countries face a number of significant barriers in transitioning from Group 2 to Group 3.

The observed patterns of growth potential and entrepreneurship carry over to the analysis of country Groups 3 and 4. Growth potential is most strongly associated (Table 9) with variables reflecting governance—especially government effectiveness, rule of law, political stability, freedom from corruption, and property rights— together with elements of competitiveness, such as the WEF's measure of institutions.

Entrepreneurship in Group 3 and 4 countries has its greatest loadings on Factor 2, economic freedom/democracy and Factor 5, health and education. Key elements in Factor 2 include investment freedom, voice and accountability, trade freedom regulatory quality, and overall economic freedom. This pattern demonstrates a subtle shift from fairly loose associations between these factors and entrepreneurship for Groups 1 and 2, to a strengthening of governance factors for Groups 2

71. As noted below, the WEF basis of classifying industries into its five groups is heavily dependent on per-capita incomes in defined ranges.



## Key Dimensions of Growth Potential and Entrepreneurship

Table 9. Factor Analysis: Growth Potential/Entrepreneurship Linkages—Country Groups 3 and 4 (loadings on principal dimensions)

Key Indicators	Main Dimensions							
	Factor 1 Growth Institutions Competitiveness	Factor 2 Economic Freedom Democracy	Factor 3 Fiscal Freedom	Factor 4 Business/ Financial Freedom	Factor 5 Health/ Education	Factor 6 Labor Market Freedom	Factor 7 Government Spending	Factor 8 Monetary Freedom
WEF Institutions	0.888	-0.047	0.348	0.068	0.052	0.055	0.038	0.050
<b>Growth Potential</b>	<b>0.849</b>	<b>-0.163</b>	<b>-0.140</b>	<b>0.299</b>	<b>0.181</b>	<b>0.256</b>	<b>0.081</b>	<b>0.041</b>
WB Government Effectiveness	0.828	0.372	-0.096	0.241	0.193	0.035	-0.055	-0.033
EF Freedom From Corruption	0.822	0.483	0.137	-0.035	0.050	-0.074	0.012	-0.063
EF Property Rights	0.789	0.446	-0.053	0.035	0.100	0.000	0.168	0.040
WB Rule of Law	0.784	0.447	0.079	0.077	0.246	0.096	-0.200	-0.080
WEF Innovation	0.768	-0.281	-0.300	0.037	0.303	0.223	-0.060	-0.069
WB Control of Corruption	0.759	0.567	0.132	-0.122	0.085	-0.026	-0.038	-0.060
WEF Goods Market Efficiency	0.758	0.096	0.298	0.305	0.062	0.262	0.199	0.222
WEF Business Sophistication	0.729	-0.097	-0.299	0.153	-0.025	0.150	0.341	0.164
WEF Infrastructure	0.704	-0.080	-0.120	-0.465	0.181	-0.051	-0.022	-0.201
WEF Financial Market Development	0.701	0.032	-0.048	0.223	-0.290	0.199	0.040	0.404
WB Political Stability	0.496	0.370	0.213	-0.096	0.251	0.000	-0.420	-0.021
EF Investment Freedom	0.053	0.881	0.282	0.066	0.092	-0.193	0.071	0.087
WB Voice and Accountability	0.075	0.832	-0.204	-0.161	0.154	0.002	-0.129	0.041
EF Trade Freedom	-0.007	0.811	0.201	0.157	-0.066	0.125	-0.172	0.071
WB Regulatory Quality	0.511	0.703	0.006	0.322	0.080	0.213	-0.073	0.146
EF Overall Economic Freedom Score	0.472	0.637	0.330	0.271	-0.049	0.115	0.340	0.163
<b>Entrepreneurship</b>	<b>0.080</b>	<b>0.509</b>	<b>0.091</b>	<b>-0.090</b>	<b>0.400</b>	<b>0.505</b>	<b>0.031</b>	<b>-0.207</b>
EF Fiscal Freedom	-0.111	0.056	0.841	0.170	-0.027	0.230	0.088	-0.044
WEF Market Size	-0.004	-0.292	-0.791	-0.022	-0.189	0.055	0.093	-0.089
WEF Macroeconomic Environment	0.355	-0.144	0.140	0.747	-0.145	0.095	-0.074	-0.075
EF Business Freedom	0.165	0.228	0.086	0.632	0.168	0.005	0.284	0.114
EF Financial Freedom	0.033	0.561	-0.001	0.622	-0.141	0.229	-0.003	0.214
WEF Health and Primary Education	0.118	0.037	0.160	-0.038	0.889	0.057	-0.071	0.050
WEF Higher Education and Training	0.547	0.092	-0.201	-0.010	0.646	0.127	-0.263	-0.135
WEF Technological Readiness	0.482	0.378	-0.148	0.341	0.541	0.026	-0.265	0.078
WEF Labor Market Efficiency	0.251	0.113	0.149	0.295	0.175	0.803	-0.053	0.059
EF Labor Freedom	0.233	-0.168	0.529	-0.138	-0.223	0.530	-0.091	0.001
EF Government Spending	0.141	-0.097	0.005	0.056	-0.158	-0.062	0.895	0.009
EF Monetary Freedom	0.026	0.163	0.039	0.040	0.027	-0.016	0.024	0.945

Notes: Extraction Method: IBM SPSS 19.0 Principle Component Analysis. Rotation Method Varimax with Kaiser Normalization. Rotation converged in fifteen iterations. WEF = World Economic Forum Dataset; EF = Heritage Economic Freedom Dataset; WB = World Bank Governance Dataset. Entrepreneurship: World Bank Enterprise Snapshots (WBGES) 2010.

### Mean Factor Scores

Group 3 Countries	-0.295	<b>-0.313</b>	0.023	-0.107	<b>-0.120</b>	<b>0.062</b>	0.280	0.084
Group 4 Countries	0.710	<b>0.752</b>	-0.055	0.257	<b>0.288</b>	<b>-0.148</b>	-0.671	-0.203
Difference: Group 4 - Group 3	1.005	<b>1.066</b>	-0.078	0.365	<b>0.408</b>	<b>-0.210</b>	-0.951	-0.287



## Key Dimensions of Growth Potential and Entrepreneurship

Table 10. Factor Analysis: Growth Potential/Entrepreneurship Linkages—  
Country Groups 4 and 5 (loadings on principal dimensions)

Key Indicators	Main Dimensions					
	Factor 1 Competitiveness Governance/ Economic Freedom	Factor 2 Fiscal Freedom	Factor 3 Financial/ Investment Freedom	Factor 4 Macro- Economic Environment	Factor 5 Market Size	Factor 6 Entre- preneurship Monetary Freedom
EF Freedom From Corruption	0.916	0.033	0.192	0.141	-0.127	0.118
WB Control of Corruption	0.904	0.005	0.188	0.176	-0.170	0.141
WB Government Effectiveness	0.887	-0.008	0.199	0.274	-0.084	0.201
WB Rule of Law	0.881	-0.100	0.239	0.183	-0.156	0.155
WEF Higher Education and Training	0.879	-0.154	0.059	-0.058	0.063	0.053
<b>Growth Potential</b>	<b>0.873</b>	<b>0.046</b>	<b>0.140</b>	<b>0.351</b>	<b>0.266</b>	<b>-0.046</b>
EF Property Rights	0.850	-0.015	0.255	0.120	-0.088	0.249
WEF Innovation	0.843	-0.106	0.045	0.159	0.319	-0.086
WEF Institutions	0.838	0.123	0.120	0.365	-0.175	0.054
WEF Business Sophistication	0.826	-0.174	0.074	0.250	0.342	-0.060
WEF Technological Readiness	0.806	0.137	0.318	0.080	0.015	0.006
WEF Goods Market Efficiency	0.790	0.249	0.198	0.397	-0.018	0.172
EF Business Freedom	0.757	0.066	0.192	-0.144	0.162	0.270
WEF Health and Primary Education	0.745	-0.211	0.003	-0.168	0.085	0.467
WEF Infrastructure	0.738	0.073	0.131	0.131	0.368	0.043
WEF Labor Market Efficiency	0.683	0.487	0.277	0.166	-0.057	0.048
WB Regulatory Quality	0.651	0.048	0.529	0.372	-0.049	0.256
EF Total Economic Freedom Score	0.631	0.551	0.426	0.142	-0.039	0.238
EF Government Spending	-0.040	0.828	0.023	0.031	-0.054	0.063
EF Fiscal Freedom	-0.337	0.824	-0.123	-0.075	-0.207	-0.047
WB Voice and Accountability	0.395	-0.663	0.293	-0.172	-0.117	0.251
EF Labor Freedom	0.276	0.625	0.085	0.143	0.053	0.111
EF Investment Freedom	0.263	0.017	0.838	0.025	-0.052	0.015
EF Financial Freedom	0.231	-0.051	0.740	0.261	0.164	0.197
WEF Macroeconomic Environment	0.169	0.109	0.193	0.836	0.077	-0.120
WEF Financial Market Development	0.427	0.165	0.123	0.760	-0.032	0.278
WEF Market Size	0.252	-0.108	0.000	0.141	0.821	-0.115
WB Political Stability	0.510	0.022	-0.209	0.192	-0.530	0.005
EF Trade Freedom	0.154	-0.043	0.445	0.129	-0.479	-0.158
<b>Entrepreneurship</b>	<b>0.177</b>	<b>0.311</b>	<b>0.251</b>	<b>-0.041</b>	<b>-0.303</b>	<b>0.719</b>
EF Monetary Freedom	0.348	-0.174	-0.045	0.288	0.407	0.626

Notes: Extraction Method: IBM SPSS19.0 Principle Component Analysis. Rotation Method Variamax with Kaiser Normalization. Rotation converged in nine iterations. WEF = World Economic Forum Dataset; EF = Heritage Economic Freedom Dataset; WB = World Bank Governance Dataset. Entrepreneurship: World Bank, Enterprise Snapshots (WBGES) 2010.

### Mean Factor Scores

Group 4 Countries	-1.033	0.458	-0.722	-0.018	-0.534	<b>-0.624</b>
Group 5 Countries	0.344	-0.153	0.024	0.006	0.178	<b>0.208</b>
Difference: Group 5 - Group 4	1.377	-0.611	0.746	0.024	0.712	<b>0.832</b>

and 3, to a greater balance between governance and economic freedom for Groups 3 and 4.

Also striking is the apparent weakening of the relationship between entrepreneurship and the factors surrounding growth competitiveness, which is fairly strong for Groups 1 and 2 but declines significantly as countries move to Groups 2–3 and 3–4.

For Groups 4 and 5 (Table 10), growth potential is defined by a balance of competitiveness, governance, and economic freedom. In contrast, entrepreneurship has little or no connection with these variables, loading weakly on the final factor, which is comprised largely of measures of monetary freedom.

The factor analysis by country groupings demonstrates the shifts that occur in the linkages associated with growth potential and entrepreneurship as the development process proceeds. In terms of growth potential, this pattern begins with a limited number of basic elements such as infrastructure and education/health, proceeds next to institutions associated with improved governance, then to governance and more economic freedom, and culminates in a final balance among all three elements: competitiveness, governance, and economic freedom.

In terms of entrepreneurship, the pattern moves from weak association with these three groups of variables in early stages of development, to stronger links with democracy and political stability, to economic freedom, and finally to a state in which there are few links to competitiveness/governance and economic freedom. These patterns suggest a tentative working hypothesis comprising three parts: (1) If entrepreneurship affects national growth potential, it does so indirectly through its influence on the institutional environment; (2) Once under way, entrepreneurship appears to spur a process of governance reform and further economic liberalization; and (3) This process is largely complete once countries reach stages

4 and 5, in which factors outside the variables examined here may play a more significant role.

### Discriminant Analysis— Key Constraints on Group Advancement

A pattern noted above was that the differences in means between groups was most significant on those factors loading heavily on growth potential and entrepreneurship (with the exception of entrepreneurship and Factor 5, growth competitiveness, for the Group 1 and 2 countries). This pattern suggests that a relatively small number of variables associated with growth potential and entrepreneurship may control movement from one stage to another.

The WEF uses two criteria for allocating countries into five stages of development. The first is the level of GDP per capita at market exchange rates as a proxy for wages, since comparable data on wages are not available for all countries. The second is the extent to which countries are factor driven, as proxied by the share of minerals in total exports. For example, countries in which minerals make up 70 percent or more of average total exports over a five-year period are deemed to be factor driven.<sup>72</sup>

The inability of Pakistan and many other countries to sustain steady growth raises the more interesting question of whether there are specific impediments that might cause a country to get “stuck” in one of these groups. Rather than per-capita income and primary product exports, are there specific governance/competitiveness/economic freedom variables associated with each pair of country groupings that constrain or delay the development process until threshold levels are reached? While not conclusive proof of causation, if the hypothesis derived from the factor analysis is correct, we should expect to find that entrepreneurship

72. World Economic Forum, *The Global Competitiveness Report 2010–2011*, 10.

## Discriminant Analysis – Key Constraints on Group Advancement

is a leading force in affecting—either directly or indirectly—these key transition variables.

To test this theory, a discriminant analysis<sup>73</sup> was undertaken to determine which variables were statistically significant in correctly classifying countries in each of the five WEF stages of development. The discriminant results start with Groups 1 and 2, with group membership gradually expanded to see

which variables come into play when more developed countries are added to the sample.

Of the twenty-eight possible profiling elements (Table 11), only two were statistically significant in separating Group 1 and 2 countries into distinct groupings based on competitiveness/governance/economic freedom. In order of importance, these were the WEF's innovation variable and the WEF's infrastructure variable,

Table 11. Country Group Profiles

Discriminating Variables in Order of Importance	Group 1	Mean Values Discriminant Groups					Pakistan
		Group 2	Group 3	Group 4	Group 5		
<b>Groups 1 and 2 (82.5% Placement as WEF)</b>		<b>Pakistan 90.4% in WEF Group 1</b>					
WEF Innovation	2.79	2.96	-	-	-	3.03	
WEF Infrastructure	2.53	3.72	-	-	-	2.75	
<b>Groups 1, 2 and 3 (75.0% Placement as WEF)</b>		<b>Pakistan 89.4% in WEF Group 1</b>					
WEF Technological Readiness	2.77	3.27	3.67	-	-	2.94	
WEF Innovation	2.80	2.95	3.05	-	-	3.03	
WEF Infrastructure	2.52	3.66	3.80	-	-	2.75	
WB Voice and Accountability	-0.49	-0.95	0.16	-	-	-1.00	
<b>Groups 1, 2, 3 and 4 (72.9% Placement as WEF)</b>		<b>Pakistan 94.1% in WEF Group 1</b>					
WEF Technological Readiness	2.78	3.29	3.67	4.38	-	2.94	
WEF Innovation	2.79	2.95	3.13	3.36	-	3.03	
WEF Infrastructure	2.50	3.71	3.80	4.64	-	2.75	
WEF Growth Potential	3.47	4.07	4.19	4.36	-	3.48	
WB Voice and Accountability	-0.53	-0.93	0.22	0.72	-	-1.00	
<b>Groups 1, 2, 3, 4 and 5 (75.0% Placement as WEF)</b>		<b>Pakistan 97.0% in WEF Group 1</b>					
WEF Innovation	2.77	2.99	3.05	3.31	4.68	3.03	
WEF Higher Education and Training	2.85	3.81	4.11	4.70	5.41	2.91	
WEF Infrastructure	2.46	3.62	3.77	4.63	5.61	2.75	
EF Monetary Freedom	70.67	65.03	72.66	73.67	79.14	69.40	
WEF Growth Potential	3.44	4.06	4.12	4.36	5.09	3.48	
WB Rule of Law	-0.77	-0.46	-0.21	0.72	1.53	-0.93	

Notes: SPSS 19.0 Stepwise Multiple Discriminant Analysis. WEF = World Economic Forum Competitiveness data; EF = Heritage House Economic Freedom Dataset; WB = World Bank Governance Dataset.

73. Adelman and Morris, "Performance Criteria for Evaluating Economic Development Potential: An Operational Approach," *Quarterly Journal of Economics* (May 1968). See also Randal Jones, "A Model For Predicting Expropriation in Latin America Applied to Jamaica," *Colombia Journal of World Business* (Spring 1980) for an early example of the use of factor and discriminant analysis in classifying countries and assessing the requirements for progression from one group to another.

which together correctly classified 82.5 percent of countries into their original WEF groupings. In the case of both variables, Group 2 countries had a significantly higher level of attainment, especially with regard to infrastructure. Pakistan was classified as a Group 1 country with a 90.4 percent probability. It scored higher than even Group 2 countries in innovation but, although above the Group 1 mean, was considerably underdeveloped in infrastructure. These results indicate that infrastructure must be developed before Pakistan can move to the next stage.

Broadening the discriminant analysis to include Group 3 countries produced another distinct profiling pattern. Four variables were statistically significant in profiling the combined group of countries into their three original WEF groupings with 75.0 percent accuracy. In declining order of statistical importance, these variables were: the WEF's measure of technological readiness, the WEF's innovation, the WEF's infrastructure, and finally, the World Bank's measure of governance, voice, and accountability.

Pakistan was again classified as a Group 1 country with 89.4 percent confidence. As in the previous analysis, it matches up well in terms of innovation, with a score in the range of the Group 3 mean. The question of whether the country will be able to overcompensate in this area sufficiently to move up the development ladder is problematic, given that it currently scores only slightly better than the mean for Group 1 not only in infrastructure, but in technological readiness.

In contrast to the other key transition variables which show steady progress as countries move to higher groupings, the mean group scores for voice and accountability decline for Group 2 countries before increasing dramatically for Group 3. This finding suggests that authoritarian regimes may be more adept at initiating a growth process, and, in fact, Pakistan's economic performance has been somewhat better under military rule. On the other hand, reliance on the military has not resulted in sustained growth. Instead, it appears that economic reforms, like the ones undertaken

by Musharraf in the early and mid-2000s, simply give rise to a new set of rent seekers intent on maintaining the status quo.<sup>74</sup> Pakistan's democratic institutions and government accountability must be immediately strengthened to sustain its progress from Group 1 to Group 2, with governance reforms continuing to facilitate the transition to Group 3.

When the discriminant sample is further expanded to include countries in Group 4, the WEF's overall growth potential variable contributes to group delineation. Most—72.9 percent—of the countries are correctly classified in their respective WEF groupings, with Pakistan having a 94.1 percent probability of remaining in Group 1.

Pakistan's score on the WEF's growth potential term is very slightly above the Group 1 norm. The growth potential term increases steadily from the lower to the higher country groupings, suggesting that a balanced attainment of many of the competitiveness measures is critical for continued advancement.

Finally, when the discriminant analysis included all five groups, six key variables were identified that create a distinct competitiveness/governance/economic freedom environment. In addition to innovation, infrastructure, and growth potential, the WEF's higher education and training, the World Bank's rule of law, and the Heritage Foundation's monetary freedom variables are statistically significant in correctly classifying 75 percent of the countries in their original WEF groupings. Pakistan is classified with a 97 percent probability as belonging in Group 1.

## Regression Analysis—Key Linkages Surrounding Entrepreneurship

The factor and discriminant analyses were both suggestive of the potentially key role entrepreneurship could play in Pakistan's transition to higher levels of development. However, while identifying key relationships, neither method is capable of definitively establishing causal relationships between entrepreneurship and other key competitiveness/governance/economic

74. Burki, *Changing Perceptions, Altered Reality: Pakistan's Economy Under Musharraf, 1999–2006* (Oxford: Oxford University Press, 2007), Chapter 1.

freedom variables. To fill this gap, a regression analysis was performed on the country sample to determine the specific factors that contribute to entrepreneurship.

**Factors Contributing to Increased Entrepreneurship**

Neoliberal thought holds that economic liberalization and increased efforts in many of the WEF’s categories of competitiveness can produce an environment conducive to the creation of new small and medium-sized enterprises (SME).<sup>75</sup> This assumption underlaid the neoliberal approach to economic reform in Chile after the fall of Allende and later became the rationale for many of the

dramatic market reforms in post-communist Eastern and Central Europe.<sup>76</sup> To test this proposition, the World Bank’s entrepreneurship (density) was regressed on the WEF’s competitiveness data set and the Heritage Foundation economic freedom variables. As with the discriminant analysis, the analysis began with Groups 1 and 2 and gradually expanded to the more developed country groupings.<sup>77</sup>

Of the competitiveness and economic freedom variables, entrepreneurship in Group 1 and 2 countries responded most strongly to improved trade freedom, followed by business freedom (Table 12). These two variables alone accounted

Table 12. Determinants of Entrepreneurial Activity (Stepwise Regression)

	Standardized Coefficient	t	Sig	df	R	R Square	Adjusted R Square
<b>WEF Group 1</b>							
<b>Model 1</b>							
EF Trade Freedom	0.584	3.447	0.002	23	0.584	0.341	0.312
<b>Model 2</b>							
EF Trade Freedom	0.565	4.114	0.000	-	-	-	-
EF Business Freedom	0.495	3.598	0.002	22	0.765	0.585	0.547
<b>WEF Groups 1 and 2</b>							
<b>Model 1</b>							
WEF Technological Readiness	0.503	3.775	0.000	42	0.503	0.253	0.236
<b>Model 2</b>							
WEF Technological Readiness	0.547	4.330	0.000	-	-	-	-
EF Fiscal Freedom	0.326	2.583	0.013	41	0.598	0.358	0.327
<b>Model 3</b>							
WEF Technological Readiness	0.540	4.451	0.000	-	-	-	-
EF Fiscal Freedom	0.266	2.131	0.039	-	-	-	-
WEF Labor Market Efficiency	0.260	2.101	0.042	40	0.649	0.422	0.378
<b>Model 4</b>							
WEF Technological Readiness	0.381	2.762	0.009	-	-	-	-
EF Fiscal Freedom	0.254	2.119	0.041	-	-	-	-
WEF Labor Market Efficiency	0.273	2.301	0.027	-	-	-	-
EF Freedom From Corruption	0.292	2.132	0.039	39	0.734	0.482	0.429

Notes: Stepwise Regression Model: IBM SPSS 19.0; Country groupings are those from the World Economic Forum Competitiveness 2010–2011 dataset. Dataset: WEF = World Economic Forum Competitiveness dataset; EF = Heritage Economic Freedom Dataset; Entrepreneurship Data: World Bank Enterprise Snapshots (WBGES) 2010. Regression Analysis was entrepreneurship on the combined WEF and EF datasets. Additional Variables: SHADOW = Size of the Shadow Economy (% GDP), WEFGROUP, group prediction dummy.

75. Looney, “Neo-liberalism” in vol. 2 of *Routledge Encyclopedia of International Political Economy*, ed. R.J. Barry Jones (London: Routledge, 2001), 1106–1110.

76. Ibid.

77. The results presented here are for countries classified in groups derived from the discriminant analysis. However, a separate analysis of the WEF groupings produced a similar set of findings.

for more than 50 percent of the fluctuation in entrepreneurship for this sample of countries.

When the sample was expanded to include Group 3, competitiveness factors, especially technological readiness and labor market efficiency, took on an added role in facilitating increased entrepreneurial activity. Increased freedom from corruption was also a critical factor at this juncture.

With the addition of Group 4, economic freedom factors were replaced by variables reflecting increased competitiveness, namely, technological readiness and labor market efficiency (Table 13). The fact that the economic liberalization reforms impact primarily the early stages of development was confirmed through regressions omitting Group 1 countries. For Groups 2, 3, and 4 and for 3 and 4 separately, only competitiveness variables—technological readiness and labor market efficiency—were statistically significant in affecting entrepreneurship.

With market liberalization, especially trade freedom and business freedom reforms, opportunities for increased entrepreneurial activity open up for Group 1 countries like Pakistan. Further increases in market reforms do not appear as critical in influencing movement through the higher stages of development, although a key market reform may still make a significant contribution to the growth of new firms.

However, while market reform can produce increased entrepreneurial activity, it is not sufficient in and of itself to create a virtuous circle of continued growth and reform. This fact is illustrated by the vicious circle in which Pakistan now finds itself, despite the market reforms undertaken by Musharraf, as well as by the experiences of several of the former European communist countries.

**Entrepreneurship and Governance**

The literature suggests that the impact of entrepreneurship on governance may play a major role in determining whether initial growth will be

Table 13. Determinants of Entrepreneurial Activity cont'd. (Stepwise Regression)

	Standardized Coefficient	t	Sig	df	R	R Square	Adjusted R Square
<b>WEF Group 1, 2, 3 and 4</b>							
<b>Model 1</b>							
WEF Technological Readiness	0.616	5.585	0.000	51	0.616	0.380	0.367
<b>Model 2</b>							
WEF Technological Readiness	0.563	5.260	0.000	-	-	-	-
WEF Labor Market Efficiency	0.269	2.508	0.015	50	0.670	0.449	0.427
<b>WEF Groups 2, 3 and 4</b>							
<b>Model 1</b>							
WEF Technological Readiness	0.529	3.373	0.001	36	0.529	0.280	0.260
<b>Model 2</b>							
WEF Technological Readiness	0.383	2.703	0.011	-	-	-	-
WEF Labor Market Efficiency	0.378	2.663	0.012	35	0.633	0.401	0.367
<b>WEF Groups 3 and 4</b>							
<b>Model 1</b>							
WEF Labor Market Efficiency	0.536	3.237	0.003	26	0.536	0.287	0.260

Notes: Stepwise Regression Model: IBM SPSS 19.0; Country groupings are those from the World Economic Forum Competitiveness 2010–2011 dataset. Dataset: WEF = World Economic Forum Competitiveness dataset; EF = Heritage Economic Freedom Dataset; Entrepreneurship Data: World Bank Enterprise Snapshots (WBGES) 2010. Regression Analysis was entrepreneurship on the combined WEF and EF datasets. Additional Variables: SHADOW = Size of the Shadow Economy (% GDP), WEFGROUP, group prediction dummy.

devolve into a vicious, or evolve into a virtuous, circle of development.<sup>78</sup> According to Havrylyshyn and Wolf,<sup>79</sup> a vicious circle is precipitated when the first set of entrepreneurs and other vested interests, content merely to live off their rents, derail the development process by blocking further governance (and possibly economic) reforms. In contrast, the creation of a virtuous circle requires entrepreneurs to take a longer-term view and push for continuing reforms to spur additional growth and increase profits.<sup>80</sup>

The analysis thus far appears to support this theory. The components of governance, with the exception of voice and accountability, show steady improvement as countries move

to higher and higher groupings. The level of improvement for both the WEF groups and the discriminant groupings used in this model appears to peak as countries move from Group 3 to Group 4 (Table 14). Control of corruption also improves markedly at this level, but reaches its maximum rate of improvement during the transition from Group 4 to Group 5.

Are these patterns, in fact, associated with pressure from entrepreneurial groups for further reforms, especially in the area of governance? After controlling for what appears to be a normal improvement in governance as countries develop, does increased governance contribute an additional amount to the upgrading of national

Table 14. Governance Patterns by Country Grouping (Group Means)

WEF Country Group	Voice and Accountability	Political Stability	Government Effectiveness	Regulatory Quality	Rule of Law	Control of Corruption
<b>Group 1</b>	-0.547	-0.685	-0.714	-0.562	-0.760	-0.732
<b>Group 2</b>	-0.739	-0.300	-0.267	-0.278	-0.394	-0.403
Difference: Group 2 - Group 1	-0.192	0.385	0.447	0.284	0.366	0.329
<b>Group 3</b>	0.015	-0.176	0.016	0.137	-0.178	-0.165
Difference: Group 3 - Group 2	0.754	0.124	0.283	0.415	0.216	0.238
<b>Group 4</b>	0.657	0.598	0.802	0.902	0.715	0.572
Difference: Group 4 - Group 3	0.642	0.774	0.786	0.765	0.893	0.737
<b>Group 5</b>	1.127	0.761	1.462	1.358	1.436	1.488
Difference: Group 5 - Group 4	0.470	0.163	0.660	0.456	0.721	0.916
Discriminant Country Group	Voice and Accountability	Political Stability	Government Effectiveness	Regulatory Quality	Rule of Law	Control of Corruption
<b>Group 1</b>	-0.535	-0.694	-0.751	-0.569	-0.774	-0.737
<b>Group 2</b>	-0.638	-0.279	-0.340	-0.374	-0.455	-0.481
Difference: Group 2 - Group 1	-0.103	0.415	0.411	0.195	0.319	0.256
<b>Group 3</b>	-0.083	-0.299	0.008	0.165	-0.215	-0.201
Difference: Group 3 - Group 2	0.555	-0.020	0.348	0.539	0.240	0.280
<b>Group 4</b>	0.650	0.577	0.789	0.889	0.719	0.557
Difference: Group 4 - Group 3	0.733	0.876	0.781	0.724	0.934	0.758
<b>Group 5</b>	1.200	0.769	1.561	1.419	1.530	1.629
Difference: Group 5 - Group 4	0.550	0.192	0.772	0.530	0.811	1.072

Notes: Data from World Bank Governance Indicators dataset for 2009.

78. From somewhat different perspectives, this theme is touched upon in William Baumol, Robert Litan, and Carl Schramm, *Good Capitalism, Bad Capitalism and the Economics of Growth and Prosperity* (New Haven, CT: Yale University Press, 2007), and Raghuram Rajan, *Saving Capitalism from the Capitalists* (New York: Crown Business, 2003).

79. Havrylyshyn and Wolf, "Determinants of Growth in Transition Countries."

80. Ibid.



governance dimensions? If a pattern exists, it may do so with a lag due to the time it takes to realize major changes in areas like rule of law or control of corruption. Thus, we would expect major gains in governance to follow somewhat behind flurries of increased entrepreneurial activity.

Regression analysis was used to identify possible linkages between improved levels of governance and entrepreneurship. Because there appears to be a normal progression of regression improvement by group (again with voice and accountability the exception), a control stage dummy variable was included as an independent variable—assuming values of 1, 2, 3, 4, and 5 to reflect the various country groupings. For the regressions involving the WEF stages,

these values replicate the country groupings. In a similar fashion, for the analysis of the progression of governance improvement through the discriminant stages, the dummy assumed the value of each of the assigned groupings.

For the WEF Groups 1 and 2 (Table 15), there are very weak linkages between entrepreneurship and increased levels of governance, with slight improvements occurring in the areas of political stability and regulatory quality. For the other measures of governance, no statistically significant linkages were found.

The picture improves somewhat for countries in Groups 2 and 3. For these countries, expanded entrepreneurship results in improved governance,

Table 15. Entrepreneurship and Improved Governance: WEF Country Groupings

Governance Measures	Standardized Coefficient	t	Sig	R Square Adjusted
<b>WEF Country Groups 1 and 2</b>				
Voice and Accountability		No Variables Statistically Significant		
Political Stability <i>Entrepreneurship</i>	0.376	2.184	0.031	0.141
Government Effectiveness <i>WEF Stage Group Dummy</i>	0.418	2.475	0.019	0.146
Regulatory Quality <i>Entrepreneurship</i>	0.444	2.619	0.014	0.168
Rule of Law		No Variables Statistically Significant		
Control of Corruption		No Variables Statistically Significant		
<b>WEF Country Groups 2 and 3</b>				
Voice and Accountability <i>WEF Stage Group Dummy</i>	0.376	2.504	0.017	-
<i>Entrepreneurship</i>	0.331	2.208	0.034	0.288
Political Stability <i>Entrepreneurship</i>	0.500	3.368	0.002	0.228
Government Effectiveness <i>WEF Stage Group Dummy</i>	0.408	2.608	0.013	0.142
Regulatory Quality <i>Entrepreneurship</i>	0.478	3.171	0.003	0.205
Rule of Law <i>Entrepreneurship</i>	0.476	3.160	0.003	0.204
Control of Corruption <i>WEF Stage Group Dummy</i>	0.402	2.855	0.007	-
<i>Entrepreneurship</i>	0.387	2.746	0.100	0.373

Notes: Stepwise Regression—Dependent Variables listed in order of entry. Data: Governance measures World Bank Governance Indicators; Entrepreneurship: World Bank, Enterprise Snapshots (WBGES), 2020. All data is for 2009.



with the exception of government effectiveness. However, as indicated by the adjusted r2 term, these linkages are not particularly strong.

Entrepreneurial linkages improve dramatically for countries in WEF Groups 3 and 4 (Table 16). Again, entrepreneurship is statistically significant for all categories of governance, with the exception of government effectiveness. More importantly, in contrast to the previous groupings, the adjusted r2 values move into the 40 percent and 50 percent range, with the exception of voice and accountability. That is, entrepreneurship accounts for nearly half the observed fluctuations in governance after controlling for the normal patterns of improvement.

Finally, countries in Groups 4 and 5 (Table 17) show few linkages between improved levels of governance and increased entrepreneurial activity. Entrepreneurship is statistically significant only in the case of regulatory quality, and even here it is a secondary factor after taking into account the progression of stages.

A slightly different pattern emerges when countries are examined in the discriminant

analysis framework. Again, there are few linkages for Groups 1 and 2 (Table 18), outside political stability and regulatory quality, between expanded entrepreneurship and higher levels of governance. The linkages that do occur are extremely weak and barely significant.

Linkages strengthen somewhat, especially in the area of voice and accountability, once countries reach Groups 2 and 3. Here entrepreneurship, along with the stage progression term, accounts for more than 60 percent of the variance across countries in voice and accountability. More importantly, for countries in these groups, entrepreneurship has a statistically significant link to all governance measures.

In sharp contrast to the findings reported above for the WEF stages, countries in discriminant Groups 3 and 4 show no statistically significant linkages with entrepreneurship (Table 19). In all cases, the discriminant stage dummy has high levels of statistical significance for all measures other than voice and accountability.

Another sharp contrast occurs between the two country grouping systems for Groups

Table 16. Entrepreneurship and Improved Governance: WEF Country Groupings cont'd.

Governance Measures	Standardized Coefficient	t	Sig	R Square Adjusted
<b>WEF Country Groups 3 and 4</b>				
Voice and Accountability				
<i>WEF Stage Group Dummy</i>	0.376	2.504	0.017	-
<i>Entrepreneurship</i>	0.331	2.208	0.034	0.288
Political Stability				
<i>WEF Stage Group Dummy</i>	0.376	2.504	0.017	-
<i>Entrepreneurship</i>	0.331	2.208	0.034	0.288
Government Effectiveness				
<i>WEF Stage Group Dummy</i>	0.418	2.475	0.019	0.146
Regulatory Quality				
<i>WEF Stage Group Dummy</i>	0.376	2.504	0.017	-
<i>Entrepreneurship</i>	0.331	2.208	0.034	0.288
Rule of Law				
<i>WEF Stage Group Dummy</i>	0.376	2.504	0.017	-
<i>Entrepreneurship</i>	0.331	2.208	0.034	0.288
Control of Corruption				
<i>WEF Stage Group Dummy</i>	0.376	2.504	0.017	-
<i>Entrepreneurship</i>	0.331	2.208	0.034	0.288

Notes: Stepwise Regression—Dependent Variables listed in order of entry. Data: Governance measures World Bank Governance Indicators; Entrepreneurship: World Bank, Enterprise Snapshots (WBGES), 2020. All data is for 2009.

Table 17. Entrepreneurship and Improved Governance: WEF Country Groupings cont'd.

Governance Measures	Standardized Coefficient	t	Sig	R Square Adjusted
<b>WEF Country Groups 4 and 5</b>				
Voice and Accountability <i>WEF Stage Group Dummy</i>	0.395	2.552	0.012	0.156
Political Stability		No Variables Statistically Significant		
Government Effectiveness <i>WEF Stage Group Dummy</i>	0.510	4.743	0.000	0.355
Regulatory Quality <i>WEF Stage Group Dummy</i>	0.418	2.998	0.005	0.284
<i>Entrepreneurship</i>	0.296	2.124	0.040	-
Rule of Law <i>WEF Stage Group Dummy</i>	0.621	4.882	0.000	0.369
Control of Corruption <i>WEF Stage Group Dummy</i>	0.545	4.008	0.000	0.279

Notes: Stepwise Regression—Dependent Variables listed in order of entry. Data: Governance measures World Bank Governance Indicators; Entrepreneurship: World Bank, Enterprise Snapshots (WBGES), 2020. All data is for 2009.

Table 18. Entrepreneurship and Improved Governance: Discriminant Analysis Country Groupings

Governance Measures	Standardized Coefficient	t	Sig	R Square Adjusted
<b>Discriminant Analysis Country Groups 1 and 2</b>				
Voice and Accountability		No Variables Statistically Significant		
Political Stability <i>Entrepreneurship</i>	0.376	2.184	0.037	0.141
Government Effectiveness		No Variables Statistically Significant		
Regulatory Quality <i>Entrepreneurship</i>	0.444	2.619	0.014	0.168
Rule of Law		No Variables Statistically Significant		
Control of Corruption		No Variables Statistically Significant		
<b>Discriminant Analysis Country Groups 2 and 3</b>				
Voice and Accountability <i>Discriminant Stage Group Dummy</i>	0.679	6.326	0.000	-
<i>Entrepreneurship</i>	0.294	2.741	0.010	0.617
Political Stability <i>Entrepreneurship</i>	0.500	3.368	0.002	0.228
Government Effectiveness <i>Entrepreneurship</i>	0.361	2.256	0.031	0.105
Regulatory Quality <i>Discriminant Stage Group Dummy</i>	0.313	2.128	0.041	0.280
<i>Entrepreneurship</i>	0.407	2.761	0.009	-
Rule of Law <i>Entrepreneurship</i>	0.476	3.160	0.003	0.204
Control of Corruption <i>Discriminant Stage Group Dummy</i>	0.293	2.043	0.049	0.316
<i>Entrepreneurship</i>	0.456	3.178	0.003	-

Notes: Stepwise Regression—Dependent Variables listed in order of entry. Data: Governance measures World Bank Governance Indicators; Entrepreneurship: World Bank, Enterprise Snapshots (WBGES), 2020. All data is for 2009.

Table 19. Entrepreneurship and Improved Governance: Discriminant Analysis Country Groupings cont'd.

Governance Measures	Standardized Coefficient	t	Sig	R Square Adjusted
<b>Discriminant Country Groups 3 and 4</b>				
Voice and Accountability <i>Discriminant Stage Group Dummy</i>	0.560	3.823	0.001	0.292
Political Stability <i>Discriminant Stage Group Dummy</i>	0.689	5.378	0.000	0.458
Government Effectiveness <i>Discriminant Stage Group Dummy</i>	0.877	10.337	0.000	0.762
Regulatory Quality <i>Discriminant Stage Group Dummy</i>	0.796	7.435	0.000	0.622
Rule of Law <i>Discriminant Stage Group Dummy</i>	0.893	11.222	0.000	0.791
Control of Corruption <i>Discriminant Stage Group Dummy</i>	0.812	7.868	0.000	0.649

Notes: Stepwise Regression—Dependent Variables listed in order of entry. Data: Governance measures World Bank Governance Indicators; Entrepreneurship: World Bank, Enterprise Snapshots (WBGES), 2020. All data is for 2009.

4 and 5. As noted, there was only a weak linkage between entrepreneurship and regulatory quality for countries in WEF Groups 4 and 5. In the discriminant country scheme (Table 20), entrepreneurship forms a highly significant link to four areas of governance: government effectiveness, regulatory quality, rule of law, and control of corruption.

What might account for these differences between country grouping schemes? As with governance (Table 14), entrepreneurial activity increases as countries move through the sequence of groupings (Table 21). However, increases in entrepreneurship between stages vary somewhat by grouping scheme. For the WEF classification framework, the highest percent increase in entrepreneurship occurs between Groups 2 and 3, with a marked falloff in entrepreneurial activity between Groups 3 and 4. In the case of the discriminant country scheme, a big jump in entrepreneurial activity occurs between Groups 1 and 2. In contrast with the WEF scheme, there is also a relatively large increase in entrepreneurship between Groups 3 and 4.

If we assume some delay between surges in entrepreneurship and improvements in governance, these different patterns of entrepreneurial expansion are roughly in line

with the observed contrasts in governance between the two classifications.

In the case of the WEF countries, the pattern is fairly straightforward: the big gains in governance observed in Groups 3 and 4 follow the maximum rate of growth in entrepreneurship that occurs between Groups 2 and 3. Because of the big drop-off in entrepreneurial expansion when countries reach Groups 3 and 4, entrepreneurship ceases to play a significant role in governance change in Group 4 and 5 countries.

The same general lagged pattern occurs for the discriminant country groupings, albeit not quite as sharply. For these countries, the largest rate of increase in entrepreneurship occurs between Groups 1 and 2. These increases are followed by improved governance in Groups 2 and 3, especially in voice and accountability, where entrepreneurship and the group dummy accounted for more than 60 percent of the observed variance across countries.

While there is a slight drop-off in the rate of growth of entrepreneurial activity from Group 2 to 3 and Group 3 to 4, it is not nearly as dramatic as the decline from Group 3 to Group 4 in the WEF scheme. As a result, entrepreneurship continues to play a significant role in improving governance for countries in Groups 3 and 4. With

Table 20. Entrepreneurship and Improved Governance: Discriminant Analysis Country Groupings cont'd.

Governance Measures	Standardized Coefficient	t	Sig	R Square Adjusted
<b>Discriminant Country Groups 4 and 5</b>				
Voice and Accountability <i>Discriminant Stage Group Dummy</i>	0.497	3.531	0.001	0.227
Political Stability <i>Discriminant Stage Group Dummy</i>	0.346	2.273	0.029	0.097
Government Effectiveness <i>Discriminant Stage Group Dummy</i>	0.770	8.628	0.000	-
<i>Entrepreneurship</i>	0.256	2.872	0.007	0.695
Regulatory Quality <i>Discriminant Stage Group Dummy</i>	0.613	5.364	0.000	-
<i>Entrepreneurship</i>	0.312	2.733	0.010	0.499
Rule of Law <i>Discriminant Stage Group Dummy</i>	0.752	7.795	0.000	-
<i>Entrepreneurship</i>	0.224	2.319	0.026	0.643
Control of Corruption <i>Discriminant Stage Group Dummy</i>	0.722	7.069	0.000	-
<i>Entrepreneurship</i>	0.233	2.282	0.028	0.600

Notes: Stepwise Regression—Dependent Variables listed in order of entry. Data: Governance measures World Bank Governance Indicators; Entrepreneurship: World Bank, Enterprise Snapshots (WBGES), 2020. All data is for 2009.

Table 21. Entrepreneurship Activity by Country Grouping

Country Grouping	Entrepreneurship	
	Discriminant Country Grouping	WEF Country Grouping
<b>Group 1</b>	0.404	0.472
<b>Group 2</b>	0.993	0.990
(% difference)	59.32	52.32
<b>Group 3</b>	2.036	2.374
(% difference)	51.23	58.30
<b>Group 4</b>	3.736	3.417
(% difference)	45.50	30.52
<b>Group 5</b>	6.267	5.948
(% difference)	40.39	42.55

Notes: World Bank: The 2020 World Bank Entrepreneurship Snapshots (WBGES). World Bank Entrepreneurship Dataset: Number of newly registered limited liability firms per 1,000 working-age population (those of ages 15–64) for the year 2009.

a 15 percent higher increase in entrepreneurship between Groups 3 and 4 than that observed with the WEF countries, entrepreneurship continues to play a significant role in the upgrading of governance for countries reaching Groups 4 and 5.

From these results, one can tentatively conclude that successful movement through higher stages of development has been associated with entrepreneurial gains resulting in subsequent improvements in governance, as seen in the virtuous circle pattern of successful reform-led growth.

**Entrepreneurship, Governance, and the Shadow Economy**

One of the main impediments to competitiveness and sustained growth is the development of a large shadow, or informal, economy. Numerous studies have documented that, while the shadow economy may provide a temporary haven for the unemployed, its low level of productivity and tax potential ultimately causes a drag on sustained rates of economic growth.<sup>81</sup> Furthermore, the

81. See for example, Looney, “The Economic Consequences of Conflict: The Rise of Iraq’s Informal Economy,” *Journal of Economic Issues* (December 2006); and Looney, “Iraq’s Shadow Economy,” *Revista Internazionale di Scienze Economiche e Commerciali* (December 2005).

development of a large shadow economy is usually one of the symptoms of the vicious circle noted above. Often with the development of a large shadow economy, insurgent and criminal groups are able to establish secure sources of financing for their operations, further contributing to ongoing instability and economic decline.<sup>82</sup>

As might be expected, the size of the shadow economy declines as countries pass through the various stages of development, although this reduction appears to stall at around 35 percent of GDP at the Group 3 level before declining rapidly to 15.25 percent as countries reach Group 4. While the shadow economy contracts as entrepreneurial activity increases, it does so at a differential rate. Recent estimates place Pakistan’s shadow economy at about 37 percent of the country’s GDP,<sup>83</sup> which is somewhat lower than the 40.45 percent mean for Group 1 countries (Table 22).

To test whether the reduction in the shadow economy is a direct result of increased entrepreneurship or the result of a more indirect process stemming from the improved governance associated with increased entrepreneurial activity, regressions were undertaken, beginning with Group 1 and gradually expanding the group sample size. For these countries (Table 23), improved goods market efficiency was the strongest factor reducing the size of the shadow economy, followed by innovation (a key element affecting the expansion of entrepreneurship for this group of countries) and fiscal freedom. The last term is logical since higher tax rates at early stages of development have been known to force many firms into informal (tax-avoidance) activities. These three variables account for more than 80 percent of the variance in the size of the shadow economies across this group of countries. Beyond these variables, entrepreneurship was not statistically significant in contributing to the regression equation. The model predicted the size of

Pakistan’s shadow economy to be 37.5 percent—quite close to its actual value of 37.1 percent.

Expanding the sample to include Group 2 countries produced a shift in factors affecting the size of the shadow economy. Now, innovation becomes the most important variable, followed by investment freedom. Regulatory quality is a marginally significant variable in increasing the size of the shadow economy. Improved regulatory quality at this stage of development may force firms that are unable to comply into the shadow economy. Finally, expanding the sample to include Group 4 and 5 countries (Table 24) resulted in the rule of law playing the dominant role in the shadow economy’s reduction.

The results for the shadow economy are roughly consistent with the entrepreneur-led virtuous circle described above and, in that sense, close the circle. For Group 1 countries, economic reforms, especially in the areas of trade and improved

Table 22. Shadow Economy and Entrepreneurship

	WEF Country Grouping	
Country Grouping	Shadow Economy	Entrepreneurship
<b>Group 1</b>	40.56	0.472
<b>Group 2</b>	35.54	0.990
(% difference)	-14.12	52.32
<b>Group 3</b>	35.10	2.374
(% difference)	-1.25	58.30
<b>Group 4</b>	27.86	3.417
(% difference)	-25.99	30.52
<b>Group 5</b>	15.25	5.948
(% difference)	-82.69	42.55

Notes: Entrepreneurship: The 2020 World Bank Entrepreneurship Snapshots (WBGES) Dataset—newly registered limited liability firms per 1,000 working age population. Shadow Economy (% GDP) from Andreas Buehn and Friedrich Schneider, “Shadow Economies and Corruption All Over the World: Revised Estimates for 120 Countries,” *Economics: The Open-Access, Open-Assessment E-Journal* (October 27, 2009).

82. Looney, “The Business of Insurgency: The Expansion of Iraq’s Shadow Economy,” *The National Interest* (Fall 2005).

83. This figure and those for our sample of countries are taken from Schneider and Buehn, “Shadow Economies and Corruption All Over the World.”

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business freedom, jump-start entrepreneurial activity (Table 12). As entrepreneurial activity takes hold, this class begins to generate more resources for growth and supportive government services. With growth, political stability becomes easier to maintain (Table 15). For successful countries that are able to continue moving up the development scale, further growth and expansion in entrepreneurial activities result in the broad improvements in governance required for sustained growth. These patterns occur in WEF Groups 3 and 4, with subsequent dramatic declines in the size of the shadow economy in Groups 4 and 5.

### Implications of the Model for Pakistan's New Growth Framework and Expeditionary Economics

Expeditionary Economics was originally formulated to assist countries emerging from protracted conflicts. For these countries, the normal policy set of foreign aid combined with a strategy of

Table 23. Determinants of the Shadow Economy (Stepwise Regression)

	Standardized Coefficient	t	Sig	df	R	R Square	Adjusted R Square
<b>WEF Group 1</b>							
<b>Model 1</b>							
WEF Goods Market Efficiency	-0.816	-5.099	0.000	13	0.816	0.667	0.641
<b>Model 2</b>							
WEF Goods Market Efficiency	-0.553	-3.637	0.003	-	-	-	-
WEF Innovation	-0.464	-3.054	0.010	12	0.901	0.812	0.781
<b>Model 3</b>							
WEF Goods Market Efficiency	-0.547	-4.151	0.002	-	-	-	-
WEF Innovation	-0.673	-4.155	0.002	-	-	-	-
EF Fiscal Freedom	-0.317	-2.222	0.048	11	0.933	0.871	0.835
Pakistan	Actual=37.1% Predicted=37.5%						
<b>WEF Groups 1 and 2</b>							
<b>Model 1</b>							
WEF Innovation	-0.638	-3.970	0.001	23	0.638	0.407	0.381
<b>Model 2</b>							
WEF Innovation	-0.679	-4.494	0.000	-	-	-	-
EF Monetary Freedom	-0.318	-2.105	0.047	22	0.711	0.506	0.461
Pakistan	Actual=37.1% Predicted=39.6%						
<b>WEF Groups 1, 2 and 3</b>							
<b>Model 1</b>							
WEF Innovation	-0.449	-2.255	0.002	42	0.449	0.201	0.182
<b>Model 2</b>							
WEF Innovation	-0.521	-3.802	0.000	-	-	-	-
EF Investment Freedom	-0.287	-2.099	0.042	41	0.528	0.279	0.244
<b>Model 3</b>							
WEF Innovation	-0.671	-4.478	0.000	-	-	-	-
WEF Investment Freedom	-0.623	-3.009	0.005	-	-	-	-
WB Regulatory Quality	0.426	2.099	0.042	40	0.592	0.350	0.302
Pakistan	Actual=37.1% Predicted=42.7%						

Notes: Stepwise Regression Model: IBM SPSS 19.0; Country groupings are those formed from a discriminant analysis of the combined dataset. Dataset: WEF = World Economic Forum Competitiveness Dataset; EF = Heritage Economic Freedom Dataset; WB = World Bank Governance Indicators dataset. Entrepreneurship Data: World Bank Enterprise Snapshots (WBGES) 2010. Regression Analysis was the size of the shadow economy (% GDP) on the combined WEF, WB and EF datasets. Additional Variable: WEFGROUP, WEF Grouping from the WEF's 2010–2011 Competitiveness Report.

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stabilization often resulted in stagnant growth and, in many cases, a relapse back to a state of conflict and instability. By emphasizing the role of entrepreneurship immediately after the cessation of conflict, the hope was that Expeditionary Economics could initiate a period of rapid recovery and sustained growth.

The results of the empirical analysis detailed in the previous section suggest that the principles of Expeditionary Economics could be adapted to an even wider range of country situations; in particular, to countries like Pakistan where stalled development, internal strife, and escalating instability threaten democratic institutions and even state survival. The study findings show that an entrepreneurship-led development approach, also a key element in Pakistan's New Growth Framework, has a solid theoretical and empirical foundation. Countries that have successfully progressed up the development ladder have

drawn heavily on entrepreneurial activity, growth, and reform in creating their virtuous circles. Entrepreneurial-focused development has the potential to reverse the vicious circles of declining formal economic activity, a growing shadow economy, and increasing violence by creating a new group of stakeholders with a vested interest in stability, development, and reform.

Of course, theoretical soundness and empirical viability are not necessary and sufficient conditions for successful implementation of any innovative strategy or policy. As Burki points out, advocates of the New Growth Framework have not come up with a plan of implementation.<sup>84</sup> In addition, there may not be enough political space to accommodate such a dramatic shift in economic policy, since powerful groups have a strong vested interest in maintaining the status quo. In the past, these groups have blocked effective economic

Table 24. Determinants of the Shadow Economy cont'd. (Stepwise Regression)

	Standardized Coefficient	t	Sig	df	R	R Square	Adjusted R Square
<b>WEF Groups 1, 2, 3 and 4</b>							
<b>Model 1</b>							
WB Rule of Law	0.517	-4.315	0.000	51	0.517	0.267	0.253
<b>Model 2</b>							
WB Rule of Law	-0.505	-4.363	0.000	-	-	-	-
WEF Market Size	-0.254	-2.195	0.333	50	0.576	0.332	0.305
Pakistan	Actual=37.1% Predicted=42.0%						
<b>WEF Groups 2, 3 and 4</b>							
<b>Model 1</b>							
WB Rule of Law	0.503	-3.429	0.001	36	0.503	0.253	0.232
<b>WEF Groups 3, 4 and 5</b>							
<b>Model 1</b>							
WB Rule of Law	-0.804	-9.835	0.000	53	0.804	0.646	0.639
<b>Model 2</b>							
WB Rule of Law	-0.793	-10.041	-	-	-	-	-
WEF Market Size	-0.176	-2.231	-	54	0.823	0.677	0.665

Notes: Stepwise Regression Model: IBM SPSS 19.0; Country groupings are those formed from a discriminant analysis of the combined dataset. Dataset: WEF = World Economic Forum Competitiveness Dataset; EF = Heritage Economic Freedom Dataset; WB = World Bank Governance Indicators dataset. Entrepreneurship Data: World Bank Enterprise Snapshots (WBGES) 2010. Regression Analysis was the size of the shadow economy (% GDP) on the combined WEF, WB and EF datasets. Additional Variable: WEFGROUP, WEF Grouping from the WEF's 2010–2011 Competitiveness Report.

84. Burki, "Credible Growth Strategy or a Wish List?" *Dawn*, May 2, 2011.



and governance reforms, trapping the country in a pattern of failed takeoffs and stagnation.

For countries like Pakistan where conflict has not swept away the old order with its entrenched interests, Expeditionary Economics may play an important role over time. A rising new progressive entrepreneurial class with a major stake in ongoing reforms is precisely what is needed to offset the influence of entrenched interests opposed to change. This new class of entrepreneurs is the best hope for overcoming existing impediments to reform and creating a sound foundation for sustained future growth.

### The Failure of Foreign Aid

Despite decades of foreign aid, the World Economic Forum classifies Pakistan's development level as Stage 1, the lowest rung of the development ladder.<sup>85</sup> Foreign aid to Pakistan has neither resulted in the kind of prosperity and stability that offer a clear alternative to extremism nor bought much goodwill for the United States.<sup>86</sup> In fact, the outcomes of massive infusions of aid have been so unsatisfactory that both donor and recipient groups agree that in many respects the country would have been better off without it.<sup>87</sup> Even aid advocates such as Nancy Birdsall and Molly Kinder concede that, "Despite millions of dollars of outside aid to support antipoverty programs, poverty was higher in Pakistan in 2004 than it was a decade earlier when the program began."<sup>88</sup> From the Pakistani perspective, there is growing dissatisfaction with ongoing aid programs, especially those provided by the United States. Pakistani politicians like Mian Shahbaz Sharif complain that existing U.S. aid programs are an

affront to national honor and that the country should only accept further inflows if conditionalities such as efforts to control corruption are removed.<sup>89</sup>

Unfortunately, the problem with this line of thinking is that, even with such conditionalities, the top-down nature of traditional foreign aid programs by definition fosters corruption. Foreign aid in Pakistan has created an entrenched elite with a vested interest in blocking reforms that threaten their rent-seeking activities. In this way, it has lessened the need for the government to forge a bond with its citizens by raising revenue and redistributing those funds as services, thus weakening the social contract and removing incentives for the country's evolution into a functional democracy capable of providing for its people.<sup>90</sup>

Even when aid manages to trickle down, the amount that actually makes it to the grassroots level is too small to make much of a difference.<sup>91</sup> According to one recent estimate,<sup>92</sup> if the United States were to withdraw all civilian economic assistance, its impact on Pakistan's GDP growth rate would be only 0.14 percent.<sup>93</sup> Perhaps just as importantly, the aid holds little value for communities that receive it, since they have scant input in designing or requesting programs to address their pressing needs.<sup>94</sup>

### Entrepreneurial Development and the New Growth Framework

An extensive quantitative analysis of the growth patterns of successful countries suggests that entrepreneurship-led development, which forms the foundation for both Pakistan's New

85. World Economic Forum, *Global Competitiveness Report, 2010–2011* (Geneva: World Economic Forum, 2010), 11.

86. Witte, "U.S. Aid Buys Little Goodwill."

87. Birdsall and Kinder, "The U.S. Aid 'Surge' to Pakistan: Repeating a Failed Experiment?" and Burki, "Living Without Foreign Assistance."

88. Birdsall and Kinder.

89. Mian Shahbaz Sharif, quoted in Burki, "Living Without Foreign Assistance."

90. Fair, "A Better Bargain for Aid to Pakistan," *The Washington Post*, May 30, 2009.

91. Aftab, "The Enigma of U.S. Aid," *The Friday Times*, April 22, 2011.

92. Arnoldy and Ahmed, "U.S. Cuts Aid to Pakistan: Six Key Questions."

93. Ibid.

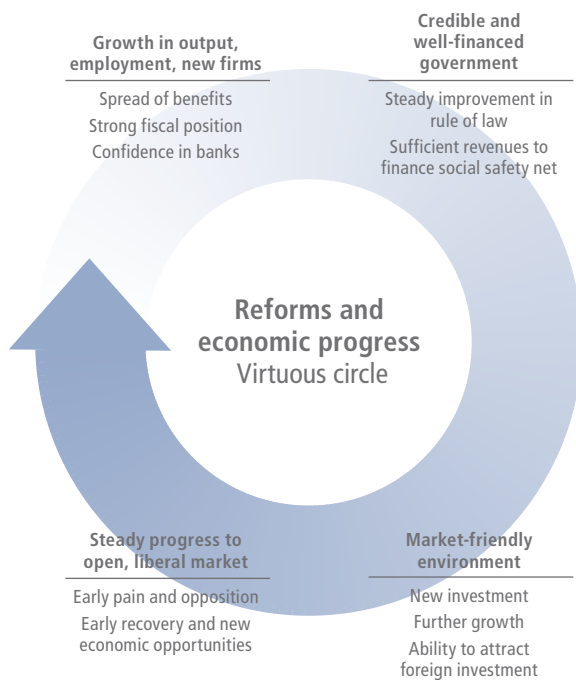
94. Aftab, "The Enigma of U.S. Aid." 95. World Bank, *Doing Business in Pakistan 2010* (Washington, D.C.: IBRD, 2010), xv.

Growth Framework and Expeditionary Economics, is a promising alternative. The analysis found that entrepreneurial activity was a key element driving the growth process through progressive stages of economic development. Successful countries that followed an entrepreneurship-led strategy, such as the Czech Republic and Poland, sustained their growth through a series of ongoing economic and governance reforms initiated by this growing stakeholder group. The result was the creation of a virtuous circle in which increased economic liberalization led to expanded entrepreneurship, increased growth, and improved governance, which in turn led to further growth and development (see Fig. 15).

According to the World Bank's *Business in Pakistan* report:

*There is no blueprint for how to grow and prosper in a challenging environment, but one factor is creating an investment climate conducive to starting and running a business, where complying with regulations brings more benefits than costs, and where an entrepreneur with an innovative idea can test the waters and succeed or fail. Where commercial regulations are simple, efficient and accessible to all, entrepreneurs can focus on what they do best—running their businesses. This is important for Pakistan where small and medium size firms constitute nearly 90% of all enterprises, employ 80% of the nonagricultural labor force and contribute 40% of annual GDP.<sup>95</sup>*

Fig. 15. Successful Reforms and Virtuous Circles



Source: Oleh Havrylyshyn and Thomas Wolf, "Determinants of Growth in Transition Countries," *Finance & Development* (June 1999).

The empirical results support this argument. For Pakistan and other Group 1 countries, trade liberalization and increased business freedom have the most stimulative effects on entrepreneurship and new firm creation, out of a wide range of governance, economic freedom, and competitiveness factors.

Local communities have some degree of control over the rules and regulations governing business, as illustrated by the wide range of differences in the ease of doing business among Pakistan's major cities (Table 25). However, while business freedom can be addressed at the local level, trade liberalization lies firmly in the hands of Pakistan's central government. According to the Heritage Foundation, Pakistan's level of trade freedom is below the norm for Group 1 countries, with import restrictions, inconsistent and burdensome regulations, and corruption adding considerably to the cost of trade.<sup>96</sup> Proponents of the New Growth Framework will need to amass sufficient support and momentum to overcome

95. World Bank, *Doing Business in Pakistan 2010* (Washington, D.C.: IBRD, 2010), xv.

96. Heritage Foundation, *The 2011 Index of Economic Freedom*.

the many entrenched groups who currently benefit from these added costs and restrictions.

Assuming these reforms can be put in place, the discriminant analysis identified innovation and infrastructure as the most important factors facilitating a country's rise from Group 1 to Group 2. Pakistan scored above even the Group 2 countries on innovation, which indicates that it has the makings of a large and dynamic entrepreneurial class. The country lags significantly, however, in infrastructure.

In the usual development sequence, the government would take the lead in addressing this deficiency in order to reduce the costs of entrepreneurial activities so their profitability becomes readily apparent. Unfortunately, Pakistan's government is notoriously bad at this type of decision-making and innovation. One advantage of the discriminant analysis approach is that it suggests ways that countries can make up for these types of deficiencies by overcompensating in other areas, in a process akin to the unbalanced growth strategy originally developed by Albert Hirschman.<sup>97</sup> In Pakistan's case, the analysis

suggests that the entrepreneurial class could assume the lead role in a Hirschman-type process.

Under this scenario, the New Growth Framework and Expeditionary Economics would encourage entrepreneurs to continue and expand their innovative activity. The entrepreneurs, in turn, would place increased pressure on the government to provide accommodating infrastructure. As the entrepreneurial class grew in strength, its influence would help spur a productive public investment program to meet specific needs and overcome well-identified bottlenecks to increased economic activity. Such a public investment program would extend not only to physical but to human capital, as the increasing sophistication of firms combines with trade-induced technology transfer to expand the demand for skilled workers.

Once growth has been jump-started, entrepreneurial reform efforts must immediately shift to governance reforms, particularly in the areas of voice and accountability, to create a virtuous circle that will allow the country to sustain

Table 25. Ease of Doing Business in Pakistan

City, Province	Ease of Doing Business (rank)	Starting a Business (rank)	Dealing with Construction Permits (rank)	Registering Property (rank)	Paying Taxes (rank)	Trading Across Borders (rank)	Enforcing Contracts (rank)
Faisalabad, Punjab	1	2	6	1	3	4	2
Multan, Punjab	2	6	1	7	3	5	4
Lehore, Punjab	3	3	3	4	3	13	8
Islamabad, ICT	4	1	8	3	1	11	10
Shelkhpura, Punjab	5	9	8	5	3	7	6
Gujranwala, Punjab	6	13	2	6	3	10	4
Sukkur, Sindh	7	10	4	10	11	3	1
Peshawar, Khyber Pakhtunkhwa	8	3	6	9	10	8	8
Karachi, Sindh	9	3	10	11	11	1	3
Rawalpindi, Punjab	10	8	5	7	3	12	10
Slalkot, Punjab	11	12	11	1	3	5	10
Quetta, Baluchistan	12	6	12	13	2	9	13
Hyderabad, Sindh	13	11	13	11	11	2	7

Note: The ease of doing business as the ranking on the simple average percentile rankings on each of the six topics covered. The ranking on each topic is the simple average of the percentile rankings on its component indicators. Source: World Bank, *Doing Business in Pakistan* (2010), 7.

97. Albert Hirschman, *The Strategy of Economic Development* (New Haven, CT: Yale University Press, 1958).

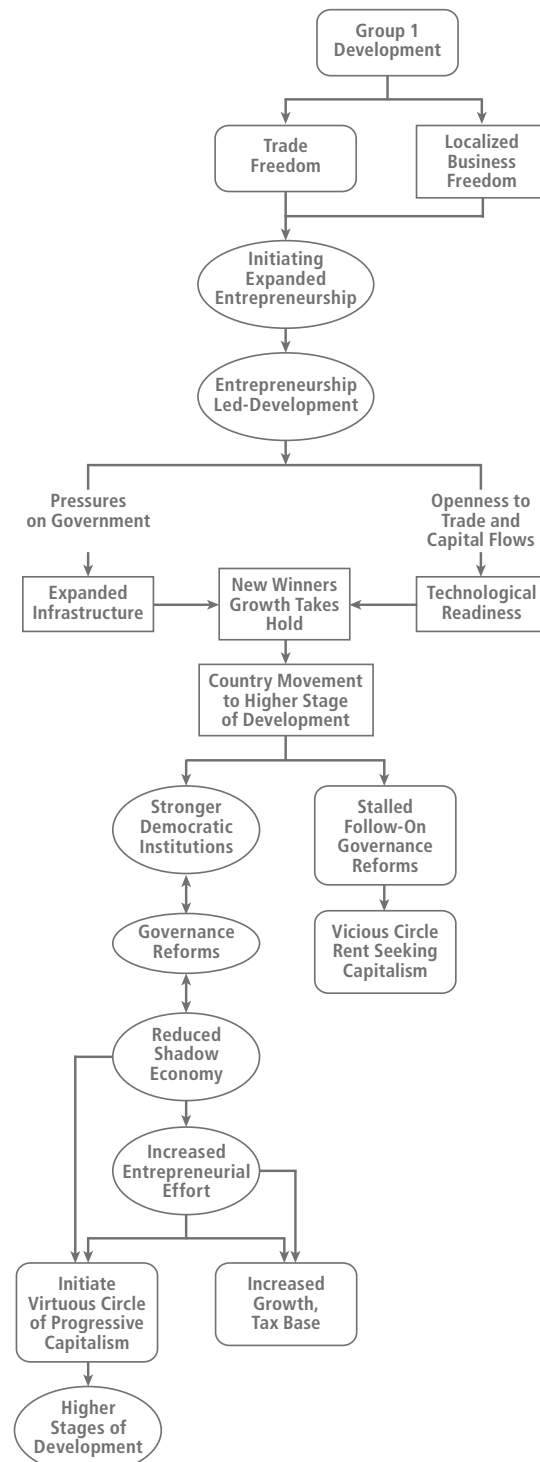
its growth and continue up the development ladder to Group 2, 3, and beyond, as illustrated in Fig. 16.

Economic reforms by Musharraf in the early to mid-2000s were not followed by improvements in governance and instead gave rise to a new set of rent seekers who blocked further reforms, stalling the economic takeoff.<sup>98</sup> Eastern European countries, like Belarus and Romania, that were unsuccessful in completing their transitions from communism followed a similar pattern and devolved into a vicious circle in which initial steps toward market reform create opportunities for rent seeking and corruption. Vested interests that benefit from these opportunities very soon establish themselves and resist further reform steps, such as allowing open entry to the market, fostering competition, providing for full liberalization, and establishing a solid rule of law. As a side effect, an underground economy emerges. Limited competition, incomplete liberalization, incentives to go underground, and the uneven rule of law can freeze the transformation in its tracks. Slow economic progress, a reversal of growth, and a collapse of financial stabilization can easily result (see Fig. 17).<sup>99</sup>

### The Application of Expeditionary Economics to Pakistan

Pakistan’s negative experiences with aid, combined with donor fatigue and the country’s resource shortages, overwhelmingly support implementation of the entrepreneurial development principles of the New Growth Framework. To gain the political support and momentum to push through the trade reforms needed for national implementation, its proponents may want to focus in the short term on implementing the framework in disaster-stricken and/or unstable and unsafe areas of the country where entrepreneurial efforts targeted to local needs could show immediate economic benefits. In these situations, Expeditionary Economics could play an invaluable role, particularly in areas of the country that are currently out of the effective reach of the central government. An examination

Fig. 16. Blueprint for Pakistani Development



98. Looney, "Failed Take-Off," 7.

99. Havrylyshyn and Wolf, "Determinants of Growth in Transition Countries." Carlotta Gall, "Floods in Pakistan Carry the Seeds of Upheaval," *The New York Times*, September 5, 2010.

of Pakistan's response to the 2010 floods and the Swat Valley insurgency demonstrates the potential benefits of an Expeditionary Economics approach.

In August/September 2010, floods affected one-fifth of Pakistan, an area roughly the size of England. The vast scope of the damage created a situation with long-term economic and political consequences, as government mismanagement of the disaster added to the distrust that many Pakistanis already felt for their civilian political leaders.

In the aftermath, there were scores of angry accusations that government officials had guided

relief only to their own party supporters. Lacking confidence in the government's ability to deliver relief, the United States and international agencies turned instead to private groups to provide assistance.<sup>100</sup>

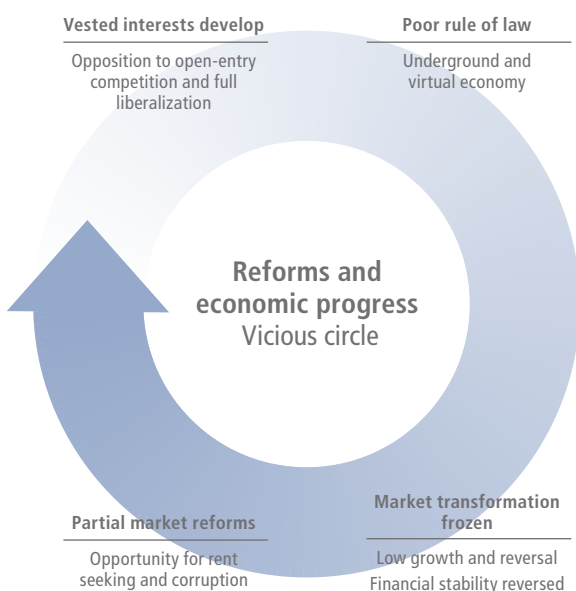
The Pakistani military stepped into the breach, greatly improving its public perception. The military was able to reach and rescue more than 100,000 flood-stranded people and coordinate sustained relief efforts in the months following the flooding.<sup>101</sup> Unfortunately, the military's efforts appear to have stopped there. Those affected by the floods were forced to rely for long-term recovery on NGOs and their own creativity: selling animals, building new mud huts, and planting more rice.<sup>102</sup>

The Pakistani military's actions in the Swat Valley, albeit a much more violent setting, won even fewer hearts and minds. In May 2009, the Pakistani army began a sustained campaign against the pro-Taliban militants then in control of the Swat region.<sup>103</sup> This campaign had widespread public support, despite the fact that the army's previous clearing operations in the area failed to hold ground, opening the population to militant reprisals.<sup>104</sup>

By July 2010, the military's scorched earth policies had largely restored law and order, and most of the valley's displaced persons had returned to their homes. While the army has proven its staying power and rightfully takes credit for stabilizing Swat, stability came at a high price for the residents, many of whom now perceive the army as an occupation force that has done little to guarantee their livelihoods or improve their standards of living.<sup>105</sup>

The Swat Valley's story is not unique. Pakistan's federal and provincial bureaucracies have also

Fig. 17. Failed Reforms and Vicious Circles



Source: Oleh Havrylyshyn and Thomas Wolf, "Determinants of Growth in Transition Countries," *Finance & Development* (June 1999).

100. Carlotta Gall, "Floods in Pakistan Carry the Seeds of Upheaval," *The New York Times*, September 5, 2010.

101. Ibid.

102. Burki, "A Weakened State," *Dawn*, September 14, 2010.

103. Economic control had been in effect since late 2008. See Aftab, "Taliban Control of Swat's Economy," *The Friday Times*, April 10, 2009.

104. This account of military action in the Swat Valley draws heavily on C. Christine Fair, "Pakistan in 2010: Flooding, Governmental Inefficiency, and Continued Insurgency," *Asian Survey* 51 (2011): 103–104.

105. Rebecca Conway, "Slow Government Development Threatens Swat Military," *Reuters*, April 15, 2011.

failed to provide systematic development and other aid to conflict-affected areas, offer adequate assistance to internally displaced persons, or engage in other efforts to create a relationship of mutual support with the locals. In addition to Swat, the government's inability to provide immediate relief has exacerbated the army's reliance on scorched-earth policies and alienated the local population in places like South Waziristan and Bajaur.<sup>106</sup> Unless efforts are quickly undertaken to improve economic activity and provide jobs, regions like these will be locked in a vicious circle of low investment and increasing poverty that is likely to lead to further instability and violence.

Training the Pakistani military and/or local police forces to implement Expeditionary Economics could vastly improve local economic recovery following natural disasters or anti-insurgency campaigns. Funds distributed by these forces to the scores of entrepreneurs who otherwise would find themselves wiped out by a disaster could be put to immediate use restoring businesses and creating jobs in local cleanup and construction. In anti-insurgency situations, forces could assist not only by identifying new entrepreneurs and channeling funding, but by providing security so they could begin or resume business without fear of violence. In both situations, the boost to the local economy would bolster the social compact by demonstrating the government's ability to care for its people.

While the application of Expeditionary Economics to Pakistan appears promising, there are some major questions that must be resolved before its success can be assured. In particular:

- Should the responsibility for implementing Expeditionary Economics be given to the military or the local police? Which will likely be better received by local communities and garner the support of local leaders?
- Currently, the Pakistani military has vast holdings of land and controls numerous industries.<sup>107</sup> If the

military is to implement Expeditionary Economics, how can its vested interests be controlled?

- Whether the funds are channeled through the military or police, what checks and balances will be necessary to prevent corruption? Performance grants that must pass annual audits to gain renewal are one option.
- Given the strong family, tribal, and political ties that exist in Pakistan, how can objectivity be assured in the selection of viable new entrepreneurs? Annual audits that look at company profits and the number of jobs produced hold promise, but might additional criteria be required?
- What types of training are best for assuring successful implementation of Expeditionary Economics within Pakistan? Would it be best to train existing officers or establish a new special corps with elite business training? Would existing programs in the country's universities and research institutes provide sufficient instruction, or would study abroad be required?

## Policy Implications

Expeditionary Economics does not exist in a vacuum. In Pakistan's case, there are a number of supporting policies both the United States/ European Union and Pakistani government can undertake to strengthen the forces set in motion by increased entrepreneurial activity at the local/ community level. In this regard, the empirical results summarized in previous sections provide a number of insights for policy design. Focus here is on overcoming the immediate binding constraints in those areas critical for initiating a renewed process of growth and entrepreneurial expansion:

- From the discriminant analysis, the immediate constraints on Pakistan's movement to a higher

106. Seth Jones and C. Christine Fair, *Counterinsurgency in Pakistan* (Santa Monica, CA: Rand, 2010).

107. Documented in Aysha Siddiqi, *Military Inc.: Inside Pakistan's Military Economy* (Ann Arbor, MI: Pluto Press, 2007).



level of development are infrastructure and innovation.

- From the regression analysis, improved freedom in trade and business freedom are the reforms most effective at encouraging increased entrepreneurship.
- Also from the regression analysis, innovation is a key factor in reducing the size of the shadow economy, thus facilitating increased productivity and tax collection. With increased entrepreneurship, innovation proceeds to complete the virtuous circle of growth and development.

### Trade Policy

In Pakistan's case, increasing trade freedom suggests that reducing Pakistan's trade barriers would facilitate an expansion of exports and imports, thus increasing domestic efficiency and generating opportunities for new export-based businesses. Pakistan's granting<sup>108</sup> of MFN (most favored nation) status to India is a major step in this regard, with significant gains for the country obtained through reducing the transaction costs of doing business between the two countries. One estimate by The Associated Chambers of Commerce and Industry of India suggests that there is potential to raise the present level of bilateral trade and investment to as much as \$10 billion with minimal additional efforts by both countries.<sup>109</sup>

For U.S. policymakers, a recent study<sup>110</sup> undertaken by the Center for Global Development puts forth the recommendation to let Pakistani

products compete in U.S. markets: "As part of an overall plan to spur private investment and job creation in Pakistan, we urge Congress and the administration to work together to extend duty-free, quota-free access to U.S. markets for all Pakistani exports from all of Pakistan for at least the next five years."<sup>111</sup> This recommendation is not new and has been put forth a number of times.<sup>112</sup> It is similar to that recently advanced by the British charity Trade Out of Poverty. A key assumption also made by this group is that aid and debt relief can alleviate poverty, but only trade can enable countries to leave poverty behind.<sup>113</sup>

There is, no doubt, some truth in the superiority of trade over aid in generating sustained growth with permanent increases in productive employment. Unfortunately, trade-based initiatives of this type are overly simplistic and, in Pakistan's case, likely fraught with a number of difficulties. For starters, given the political climate in Washington, initiatives of this sort simply will not happen in the foreseeable future.

In addition, past instances of similar trade-assistance approaches provide a very mixed picture.<sup>114</sup> The use of trade incentives is a long-standing U.S. policy. Especially during the Cold War, trade and access to the U.S. market were used to strengthen allies such as Taiwan, South Korea, Israel, and on a smaller scale, a host of other friendly governments. Implicit in this strategy was the belief that improved trade and incomes would set in motion a virtuous circle of further economic and governance reforms as countries sought to improve efficiency and competitiveness. In turn,

108. Vivek Katju, "MFN Status to India: Move by Pakistan is Based on Logic," *India Today*, November 4, 2011.

109. Aftab Ahmad Chaudhry, "A Multi-Dimensional Benefit," *The News*, November 8, 2011.

110. Nancy Birdsall et al., *Beyond Bullets and Bombs: Fixing the U.S. Approach to Development in Pakistan: Report of the Study Group on a U.S. Development Strategy in Pakistan* (Washington, D.C.: Center for Global Development, June 2011).

111. Birdsall, et al., *Beyond Bullets and Bombs*, 2.

112. Summarized in Looney, "Problems in Using International Trade to Counter Terrorism: The Case of Pakistan," *Journal of South Asian and Middle Eastern Studies* (Summer 2003).

113. Peter Lilley, et al., "Trade Out of Poverty," *World Economics* (April–June 2011).

114. The following summarizes the main findings on trade access, economic reform, and growth presented in Looney, "U.S. Middle East Economic Policy: The Use of Free Trade Areas in the War on Terrorism," *Mediterranean Quarterly* (Summer 2005). For the Pakistani case, see Looney, "Problems in Using International Trade to Counter Terrorism."



improved economic efficiency and governance further expanded the economies' gains from trade.

What happened in practice? Virtuous circles or something closely resembling them were attained in countries such as South Korea, Taiwan, and Costa Rica, where the preexisting social and political conditions were more or less conducive to development and—at least eventually—democracy. On the other hand, only very limited successes were achieved in countries such as Haiti, Honduras, Indonesia, and the Philippines. These were countries where the preexisting conditions were less amenable to economic and political liberalism.

Pete Moore and Andrew Schrank go as far as to conclude the following:<sup>115</sup>

*In fact, the lessons of history are clear. Trade alone will tend to underpin—rather than to undermine—preexisting social and political arrangements ... If trade and aid are offered conditionally (i.e., as a quid pro quo for political or foreign policy reform), they risk igniting a nationalist, anti-American, and quite possibly Islamist backlash—particularly if the conditions are perceived to benefit the United States or Israel rather than Arab firms, investors, and citizens. If they are offered unconditionally, however, they threaten to do little more than enrich already powerful and self-serving elites and to thereby undermine the prospects for peace and prosperity in the Middle East.*

Trade access to the United States or European markets appears to set off a virtuous circle of growth and reform only in those countries that have already achieved a relatively high level of economic freedom and governance. The less successful countries' difficulties stem from the fact that there seem to be only limited linkages

between freer trade and the major dimensions of governance.<sup>116</sup> Pakistan falls in this category.

If Pakistan had been a country with years of good governance, experiencing strong, stable investment patterns while undergoing increased globalization and possessing a highly literate workforce, open trade with the United States might have opened up numerous opportunities for the country. The reality is that Pakistan has experienced poor export growth and low-export competitiveness for decades. As Chaudhry<sup>117</sup> notes, the country's traditional export model involves sending a small group of low-tech and low-value products—notably textiles and clothing—to an equally small set of destinations such as the United States and Europe. As noted above, innovation and increased trade freedom will be critical first steps in advancing the country's growth. This kind of trade pattern is not ideal any more in a world which is being shaped by innovative products and services:

*Therefore, Pakistan could also broaden and integrate its economy by focusing more on trades in several sectors such as information technology, financial, health and entertainment services, energy, telecom and tourism sectors. The improvement in bilateral trade with India, whose economy has undergone a sustained period of diversification, would also enable Pakistan to focus on a modern export development strategy. Increased competition with the regional markets is expected to focus the country on the need to increase both the volume and value of exports through product diversification and value enhancements.<sup>118</sup>*

In sum, United States and European efforts should be focused on encouraging and facilitating more trade for Pakistan on a regional level. World Bank studies<sup>119</sup> suggest that trade based on geographic proximity offers more

115. Pete W. Moore and Andrew Schrank, "Commerce and Conflict: U.S. Effort to Counter Terrorism with Trade May Backfire," *Middle East Policy* (2003).

116. Looney, "U.S. Middle East Economic Policy," 111–112.

117. Chaudhry, "A Multi-Dimensional Benefit," *The News*, November 7, 2011.

118. Ibid.

119. Summarized in Uwe Deichmann and Indermit Gill, "The Economic Geography of Regional Integration," *Finance & Development* (December 2008).

opportunities for countries at Pakistan's level of development and industrial sophistication than trade with distant developed countries.

Small to medium-sized enterprises (SMEs) comprise 85 percent of entrepreneurial businesses in Pakistan. They employ approximately 78 percent of the non-agricultural labor force and contribute more than 30 percent to Pakistan's GDP and 25 percent of the country's exports of manufactured goods.<sup>120</sup> Trade at the regional level would enable the country, through new entrepreneurial activity, to find niches in the supply chain, supplying countries like China with critical parts and supplies.

The United States/European Union can play an extremely important role through aid for trade programs (AFT) in assisting Pakistan in its integration into export markets. Aid for trade is development assistance targeted at building up the country's capabilities, knowledge, and infrastructure in order to empower and enable new entrepreneurs and start-up firms' integration into export markets.

Development assistance in the form of AFT rests on the idea that overcoming these constraints necessitates additional costs and greater investment, which Pakistan cannot provide on its own. The rationale is based on the fact that removal of tariff and nontariff barriers is a necessary yet insufficient tool for market access.<sup>120</sup>

In addition, AFT can assist in overcoming many of the risks to trade liberalization noted above. Specifically, AFT can be used by the United States/European Union as an instrument to advance Pakistani trade liberalization in exchange for aid. This assistance could be aimed not just at assisting new firms, but also toward sectors likely to face losses from liberalization and subsequent restructuring costs.<sup>121</sup>

## Infrastructure Policy

The empirical results noted above, together with limitations on stimulating the Pakistan economy through increased trade linkages, suggest that direct U.S. involvement in enabling the country to overcome its infrastructure constraints is the most productive course of action at the present time. Several areas of infrastructure appear especially promising in relieving growth/entrepreneurial constraints.

According to the Legatum Institute's Prosperity Index for 2011,<sup>123</sup> a broad assessment of country development and growth prospects, Pakistan places close to the global average for its level of R&D expenditure, indicating a potentially favorable environment for entrepreneurship. However, according to the index, the country only earned a disappointing \$6 million from royalty receipts in 2009, and ICT exports account for just 0.3 percent of total goods exports. This pattern can be traced to another constraint facing Pakistan: the country's communications infrastructure is weak—only around 60 percent of the population own a mobile phone, Internet bandwidth capacity is equally poor, and there are very few secure Internet servers, all of which suggests a weak infrastructure for entrepreneurship. The United States could help here by providing or subsidizing political risk insurance for U.S./Pakistani firms contributing directly or indirectly to the country's communications infrastructure.

In terms of direct assistance for infrastructure, the United States can play a significant role in regard to post-flood reconstruction, but perhaps even more importantly in the energy area. Since 2006, Pakistan has been facing an energy crisis,<sup>124</sup> which has worsened in the last four years: the domestic energy shortfall is estimated to be in the

120. ul Haque, "Towards a New Development Approach," *The Friday Times*, October 8, 2010.

121. Oxford Analytica, *International: Aid for Trade Will Attract Companies*, October 28, 2011.

122. Ibid.

123. <http://www.prosperity.com/country.aspx?id=PK>.

124. Looney, "Energy and the Pakistani Economy: An Exploratory Analysis to 2035," in *Powering Pakistan: Meeting Pakistan's Energy Needs in the 21st Century*, ed. Robert M. Hathaway and Michael Kugelmann (Oxford: Oxford University Press, 2009), 39–50.

range of four to six gigawatts; around 40 percent of households have no access to electricity; the vital textile export industry lost nearly \$4 billion last year as irregular supplies forced factories to close down for 100 days; and government subsidies to the power sector, which cost 220 billion rupees (\$2.5 billion) per annum, drain resources from education and healthcare programs.<sup>125</sup>

According to the government, overall energy supplies will need to be increased by at least 10 percent a year until 2015 to sustain growth. In order to boost power generation in the long term, the authorities have turned to international support for the development of the hydroelectricity, mining, and nuclear energy sectors. China is playing a leading role in all these areas.

Growing gas shortfalls have accelerated plans for an Iran-Pakistan gas pipeline project, from which India has withdrawn at the United States' request:

- Under the present bilateral Gas Sales Agreement, the 800 kilometer pipeline to Nawabshah (Sindh) would supply 750 million cubic feet of gas per day starting in 2014, which would be used to generate 4,500 megawatts of electricity. The government hopes the pipeline will eventually supply more than 1 billion cubic feet of gas per day at 78 percent crude oil parity price.
- However, this project could be blocked if Pakistani companies that import Iranian gas are barred from accessing the U.S. financial system and U.S. market under the terms of sanctions against Iran.

Because of the critical role that energy will play in either advancing or constraining Pakistani growth, U.S. efforts would be most productive in matching China's efforts at increasing domestic supplies, while removing its objections to gas deals with Iran. The ongoing opposition to Iranian gas is only fueling anti-American resentment in Pakistan.

## Business Freedom/Removing Constraints on Entrepreneurship

The final immediate constraint on growth and entrepreneurship in Pakistan centers on business freedom. While the United States and European countries cannot do much directly to change the country's business climate, they can assist, as in the energy area, in removing some of the constraints to entrepreneurship.

Probably the simplest way open to the United States and European Union of increasing the number of entrepreneurs is to assist funding Pakistan-based NGO microcredit organizations. While controversial, there is growing acceptance of the role of microcredit in initiating growth and development and thus expanding the entrepreneurial class. As a recent survey of the literature concludes:<sup>126</sup>

*Co-finance has steadily grown to provide credit to hundreds of thousands of individuals living in third world countries. The spreading of and innovation within the microfinance sector demonstrates a successful neoliberal initiative that is both socially conscious and economically beneficial. By connecting groups of poor individuals to lending institutions or affluent individuals in developed countries, microloans have been able to foster the strengthening of local economies, necessary for consuming life-improving technology, while incurring minimal risk to the lending party. Criticisms of microfinance—both non-profit and for-profit models—appear misguided as there are clear data demonstrating both a low incidence of default and modest interest rates. Moreover, credit has been the foundation for modern economic growth. Ethical lending to the Third World should*

125. Oxford Analytica, *Pakistan: No End in Sight for Deepening Energy Crisis*, January 25, 2011.

126. Gregor Campbell, "Microfinancing the Developing World: How Small Loans Empower Local Economies and Catalyze Neoliberalism's Endgame," *Their World Quarterly* (2010).

*therefore not be denied, but rather intensified through the faculty of microfinance.*

Building up a large growing entrepreneurial class has broader benefits than simply setting the stage for more rapid growth in the short term. Over time, it lays the potential foundation for sustained growth and, with improved governance, the virtuous circle of expanded entrepreneurship, business activity, and reform. Hopefully, as in the case of many successful former communist countries in Central and Eastern Europe, expanding numbers of entrepreneurs will exert increased pressure on the government to enact more business-friendly laws and regulations.

### Assessment— Mancur Olson’s Coalitions

Whether expanding numbers of entrepreneurs will play this positive role depends on which of Mancur Olson’s<sup>127</sup> coalitions dominate over time. Olson distinguished between distributional coalitions, which are seen as leading to outcomes inimical to economic growth, and encompassing coalitions, which are seen as potentially aiding economic growth in a society. For Olson, the equilibrium-upsetting crisis of losing a war explained postwar growth in Japan and Germany. By making possible reforms that neutralized entrenched vested interests, the crisis produced a fresh environment in which the benefits of public institutions and policies could be distributed more widely.

The Olsonian framework enables a deeper insight to Pakistan’s stalled development. The literature on Pakistan is replete with laundry lists of what the country should do to turn the economy around: increase tax revenues, invest more in education, reduce defense expenditures, and on and on. There is nearly uniform consensus among economists as to what changes the country will

have to undertake if it is to restore high rates of sustained growth. Clearly, if it were simply a matter of implementing sound policies, the country would have become a developed country long ago.

The answer to the country’s lack of economic progress can, in large part, be traced to Olson’s distributional coalitions that currently are dominant in Pakistan, blocking reforms and stifling the development of encompassing coalitions. The country’s distributional coalitions consists of feudal landlords blocking land reform,<sup>128</sup> military coalitions protecting their vast network of industries,<sup>129</sup> as well as trade with India, and groups of favored industrialists (crony capitalists) that rose to power in the freewheeling Musharraf days.<sup>130</sup>

These distributional coalitions have created an extremely unstable environment that can be traced in large part to low government revenue caused by the various groups’ use of tax evasion, loopholes, and exemptions. Fewer than three million of Pakistan’s 175 million citizens pay any income taxes, and the country’s tax-to-GDP ratio is only 9 percent. Tax evasion means that fewer resources are available for essential social services. “Pakistan spends too much on defense and too little on development: It has spent twice as much on defense during peacetime as it has on education and health combined,” said S. Akbar Zaidi. “The government knows how to increase its revenue through tax reform, but the rich and powerful have resisted such measures for fear of lowering their own incomes.”<sup>131</sup>

Industrial policies during the Musharraf days offer insight into past mistakes that will need to be avoided in the future if Pakistan is to develop a dynamic entrepreneurial class. Specifically, under Musharraf the government gave an enormous amount of freedom to private entrepreneurs. The government played a minimal role, intervening only when the private

127. Mancur Olson, *The Rise and Decline of Nations: Economic Growth, Stagflation and Social Rigidities* (New Haven: Yale University Press, 1982). See also Olson, “The South Will Fall Again: The South as Leader and Laggard in Economic Growth,” *Southern Economic Journal* (1983).

128. Mosharraf Zaidi, “Pakistan’s Rent-Seeking Missiles,” *The News*, March 2, 2011.

129. Cf. Ayesha Siddiqi, *Military Inc.*

130. Burki, *Changing Perceptions, Altered Reality*.

131. S. Akbar Zaidi, “Pakistan’s Roller-Coaster Economy: Tax Evasion Stifles Growth,” *Carnegie Policy Brief*, September 2010.

sector felt it was faced with unfair competition from abroad. This allowed private monopolies to develop at the expense of the consumer. Protected by the state, some sectors developed rapidly but not competitively. The automobile sector is an example which thrived behind the wall of protection that was built around it.<sup>132</sup>

Overall, the manufacturing sector is narrowly based and stuck in products for which global market demand is either stagnant or shrinking. Entrepreneurial and innovative energies are misplaced and largely directed toward rent-seeking activities such as subsidies, protection, and tax evasion.<sup>133</sup>

Fortunately, there are some indications that Pakistan’s distributional coalitions are weakening, providing the opportunity for an expanding class of new entrepreneurs forming a broad-based encompassing coalition capable of turning the reform tide against the distributional coalitions. With democracy, in the last few years one sees some weakening of the military as evidenced by the granting of MFN (most favored nation) status to India. Freer trade may also weaken somewhat the entrenched position of the Musharraf-era industrialists.

As for the feudal landlords, the picture is mixed. Vast estates belonging to feudal families stretch out across the country, sometimes covering hundreds of acres. According to the World Bank, about 2 percent of households control more than 45 percent of the total land area. Large farmers also have monopolized subsidies in water and agriculture—with the system in place contributing heavily to rural poverty.<sup>134</sup>

In a feudal country where landlords have strong influence, landless farmers face great difficulty in recovering their livelihoods. Because landlords have so much power, farmers have been forced to pay high interest rates while

receiving small returns from crops. This system places many into a constant cycle of debt.

Many of the flood victims in refugee camps or those taking up new residence in the country’s urban areas are escaping the country’s brutal rural feudal system. For those remaining on the land, the floods have only compounded the problems faced by the landless farmers and peasants. They have lost their livelihoods and shelter. Because they do not own the lands or their houses, most do not qualify for government compensation. This money has gone to the landowners. In addition, the government’s cheap loans and other facilities have gone to the feudal lords and big farmers, with little offered to the poor peasants and small farmers. These groups have been forced to turn to the exorbitant rates offered by private money lenders and the feudal lords.

For its part, the government has offered inexpensive loans and other assistance to the feudal lords and big farmers, but little or nothing to the masses of peasants and small farmers. Instead, these groups have been left on their own. In short, the floods will further impoverish the hundreds of thousands of already extremely poor peasants and farmers. The sad situation is best summarized by Rebecca Anne Dixon and Ambassador Teresita Schaffer:

*Some observers suggest that the disaster will change the feudal system under which much of Pakistan’s rural farming areas still operate. What is more likely is that it will exacerbate the competition for land and work among the “have-nots” of the large landholdings in Sindh and southern Punjab. Hard times generally reinforce existing dependency relationships in parts of Pakistan that have large landholdings. The Pakistan floods, although prompting a measure of demographic change, have not had the radical*

132. Burki, “State, Entrepreneurship and the Common Good,” *Dawn*, August 16, 2010.

133. Ishrat Husain, “Preparing for the Future,” *The News*, July 4, 2011.

134. “Pakistan: Floods Uncover Evidence of Feudalism’s Impact on Poor,” *AlterNet*, February 17, 2011.



*impact on the will of the federal government that would be required to counter this trend.*<sup>135</sup>

Increased employment opportunities in the more urban areas for those escaping from feudalism would seem to be the best alternative to weakening the feudal system at this point. Microfinanced small industries could play a vital role in this regard.

As Safiya Aftab has noted, the post-floods situation did present a unique opportunity to undertake tough economic reforms “instead of looking towards the world to bail Pakistan out of a major crisis. The floods are a game-changer and we may never go back to being in a position where the next SBA bails us out. Let us by all means fulfill our international obligations, but let’s not think that we can just muddle on as before, periodically blackmailing the world with the threat of the consequences of collapse of a nuclear power dealing with growing militancy. The world simply does not have the resources to get us out of this mess.”<sup>136</sup>

It is unclear whether the floods in and of themselves convinced the government to initiate the country’s New Growth Framework (approved as the country’s official development strategy in May 2011). If they did, and Olson’s encompassing coalitions begin to grow as a result of expanded entrepreneurship stimulated by the free market policies incorporated in the framework, then the floods may well be responsible for a gradual shift in power from stagnation and poverty to reform and broad-based growth.

## Conclusion

As originally conceived, Expeditionary Economics was seen as an effective tool in restoring economic growth and prosperity to post-conflict situations.

Although devastated by recent conflict, these countries possessed an active entrepreneurial class capable of responding quickly to opportunities opened up by improved security and the support of the U.S. military. Presumably the conflict had removed or weakened previous institutional and interest group impediments to entrepreneurship, giving the country a clean slate and fresh start in creating a viable, dynamic economy.

The present study has focused on Pakistan, where instability and conflict are ongoing and well-established groups with strong vested interests abound. Even in such a situation, the results presented above suggest that an entrepreneurial-based development strategy is on firm theoretical and empirical grounds. The results imply that in Pakistan’s case, the implementation of Expeditionary Economics in conflict and disaster situations has the potential to produce immediate gains in growth, employment, and stability. Over time, the institutional reforms induced by the entrepreneurial class would enable the country to overcome existing impediments to sustained growth and move to higher levels of development.

In summary, the study found that (see Fig. 18):

- It is unlikely in Pakistan’s current institutional/political setting that traditional aid programs, even with greatly expanded funding, could initiate a process of institutional development and reform sufficient to offset Pakistan’s current slow growth and cycle of violence.
- However, an extensive quantitative assessment of successful country growth patterns found that entrepreneurial activity is a key element in driving the growth process through progressive stages of economic development.
- Successful countries whose development relies on increased entrepreneurial activity appear to sustain growth through a series of ongoing reforms initiated by this growing stakeholder group. As a result, they are able to establish virtuous circles of increased economic liberalization, extended

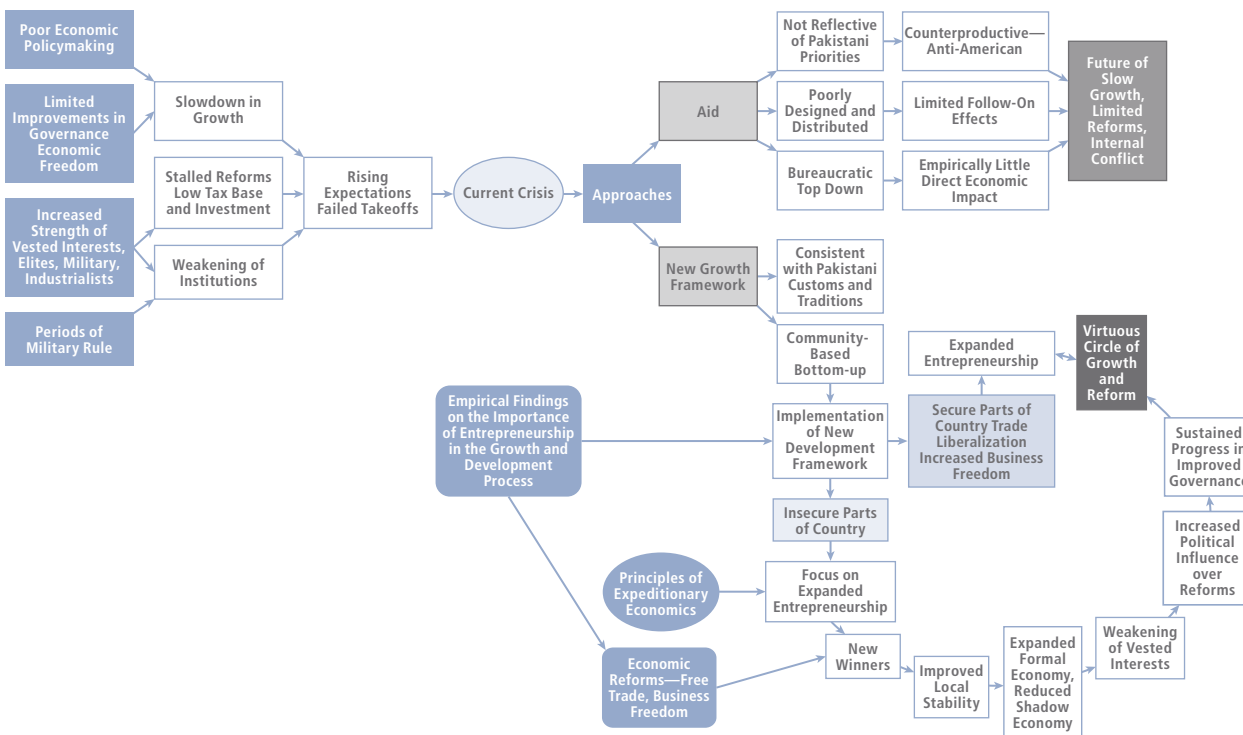
135. Rebecca Anne Dixon and Ambassador Teresita Schaffer, “Pakistan Floods: Internally Displaced People and the Human Impact,” Center for Strategic and International Studies *South Asia Monitor* no. 147 (2010): 2.

136. Aftab, “Revamping the Economy,” *The Friday Times*, September 10, 2010.

- entrepreneurship, expanded growth, and improved governance, which lead in turn to further growth and development.
- Increased trade liberalization and improvements in the business climate are the most important factors for stimulating entrepreneurial expansion for countries at Pakistan’s stage of development.
- Consequently, entrepreneurial efforts could be expanded in the short term without major improvements in governance.
- Entrepreneurship-led development could potentially create a virtuous circle of growth and reform in Pakistan capable of overcoming the constraints of violence, bureaucratic inertia, and the country’s many vested interests.
- In principle, Pakistan’s New Growth Framework incorporates all of the elements noted above.

- The principles of Expeditionary Economics should facilitate a policy shift toward the New Growth Framework, especially in areas where the central government has thus far been unable to be an effective agent for economic betterment.
- There are numerous opportunities for the United States and European Union to contribute to Pakistan’s economic revival and sustained growth.
- Finally, although Pakistan is not strictly a post-conflict setting, but one that shares many similar elements of instability, the empirical findings highlighting the importance of trade liberalization and increased business freedom provide a tentative answer to one of the research agenda questions originally posed by Rebecca Patterson and Dane Stangler: “How to develop and promote a private business sector in post-conflict countries.”<sup>137</sup>

Fig. 18. Overview of Findings



137. Rebecca Patterson and Dane Stangler, “Building Expeditionary Economics: Understanding the Field and Setting Forth a Research Agenda” (Kansas City, MO: Ewing Marion Kauffman Foundation, November 2010), 13.





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