

Policy Brief Series

# PAKISTAN'S URBANIZATION



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## ENABLING ENTREPRENEURIAL INNOVATIONS TO SERVE PAKISTAN'S URBAN POOR

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### Policy Recommendations

- Provide patient capital to early-stage pioneering enterprises serving the urban poor so that they can validate and scale their business models.
- Leverage bank financing for growth-stage enterprises through risk-sharing guaranty facilities.
- Set up urban innovation labs and incubators—focusing on first-time young entrepreneurs—to test new business ideas for serving low-income urban populations.
- Capture learnings from similar countries using market-based models to serve the urban poor.

Recommendations continued on next page

This policy brief series seeks to share with a wider audience the proceedings of a November conference at the Woodrow Wilson Center that explored the challenges presented by Pakistan's rapid urbanization. The Wilson Center's Asia Program takes great pleasure in acknowledging support provided by the *Fellowship Fund for Pakistan* for the conference, this policy brief series, and the longer volume of essays to be published in 2014.

### Policy Recommendations (continued)

- Provide consumer financing to low-income households in general and targeted subsidies to the poorest segments of the population.
- Provide government support to private businesses serving low-income markets by simplifying regulations and providing financial incentives like tax breaks.

### PAKISTAN'S URBAN POOR AND THE POTENTIAL OF ENTREPRENEURIAL INNOVATIONS

Pakistan has been undergoing urbanization since its creation, a phenomenon that has rapidly accelerated over the past couple decades. According to official estimates, 35 percent of Pakistan's population in 2012 lived in urban areas. By 2025, based on current trends, a majority of Pakistan's population will likely be urban. While this urbanization trend presents new economic opportunities for Pakistan, it also presents major challenges for the country and its cities/towns. These include revisiting city design and planning, building competitive and dynamic urban economies, and upgrading urban physical infrastructure.

The overwhelming majority of Pakistan's urban population comes from the lower income and poor categories. Eighty percent of Pakistan's urban households make 26,000 Pakistani rupees (Rs.) or less per month (about \$250 a month as per current exchange rates), while 60 percent make less than Rs. 21,000 per month. One of Pakistan's central urbanization challenges is effectively catering to the essential needs—housing, water, sanitation, transportation, health, and education—of the lower-income segments of the urban population so that these people can enjoy a decent standard of living and be productive members of Pakistan's economy.

The standard expectation is that the basic

needs of the population—including low-income groups—should be met by the public sector (through the federal, provincial, and local governments). Indeed, government—because of its resources and its mandate to serve the public—needs to be the lead actor in serving the urban poor. However, the traditional government approach to providing public services suffers from limitations. Weak management capability and widespread corruption in government bureaucracies mean that in general, public sector initiatives are poorly designed and executed. Additionally, large fiscal deficits and the absence of cost-recovery in government programs prevent them from scaling to serve the whole population. Finally, top-down mindsets coupled with an aversion to risk-taking constrain innovation in public service delivery that is more responsive to the needs of low-income groups. These limitations are certainly not unique to Pakistan; they are fairly common in much of the developing world, including elsewhere in South Asia and in Africa.

Over the last 10 to 15 years, developing countries have seen the emergence of private sector companies serving low-income groups in both urban and rural areas. Such companies use market-based mechanisms to provide essential products and services at affordable price-points to vast but underserved lower-income markets. They have typically been led by dynamic entrepreneurs innovating with business models that aim to be both financially viable and

operable on a large scale, while also developing a product/service that creates economic or social value for low-income groups. Such pioneering models—if successful over time—can catalyze new industries and sectors that bring in the mainstream private sector, and also offer lessons and insights for the public sector in relation to policy refinements and service delivery programs.

Private sector approaches and market-based models to serve the urban poor in Pakistan are still relatively new, led mostly by a small group of social entrepreneurs, particularly in the field of microfinance. The traditional private sector—barring the mobile telecom sector—has catered mainly to the upper and middle income segments. The informal and semi-formal private sector, however, is the principal source for serving the urban poor—catering to their housing, water, education, healthcare, and transportation needs. While the products and services offered are of mixed quality (ranging from decent to very substandard), they do demonstrate that urban low-income groups constitute a market opportunity for businesses willing to serve them.

Where can private sector entrepreneurial models work in serving Pakistan's urban poor? One key area is low-income housing. The overwhelming bulk of the backlog of 5 to 7 million housing units is in the lower income category, and at least 35 percent of the urban population in Pakistan lives in slums or informal settlements. Government policies and programs have not catered in any way to the urban poor, whereas formal private sector developers have served upper and middle income segments. Most formal housing that is developed is well beyond the financial means of the bottom 60 to 70 percent of the population. However, a few innovative early-stage housing models offer promise and insights on how to provide affordable housing to lower-income groups. One

of these is Saiban's "Khuda-ki-Basti" project in Karachi and Lahore, which uses an incremental housing development approach (where physical infrastructure and individual homes are built incrementally over a few years) to make housing and home ownership affordable for very poor households. Another example is a new model being developed by Ansaar Management Company (AMC), a private developer in Lahore. AMC is developing and selling small housing units ranging in cost from Rs. 500,000 to Rs. 750,000 and arranging bank financing to make these homes affordable to their target group of low-income families. Neighboring India can offer instructive lessons as well. In recent years, there has been an emergence of a private sector-led affordable housing industry targeting lower income segments of the population. Over 50 commercial private developers are building affordable housing projects across India's cities, and seven to eight housing finance companies are catering to the lower-income market.

A second area where private sector entrepreneurial models can help Pakistan's low-income groups is the provision of clean drinking water. While there is widespread access to water across urban Pakistan, drinking water contamination is a serious problem, with major outbreaks seen in major cities in recent years. The ideal solution is for all tap water provided by municipal governments to be adequately treated and to be free of contaminants. However, this is currently not available, and bottled drinking water, while available, is affordable only to upper and middle income groups. One private company in Lahore, Pharmagen Healthcare, has learned from similar successful models in South Asia and Africa, and has developed an innovative model whereby it has set up community-level water purification plants and outlets in low-income neighborhoods. From these facilities, Pharmagen is selling high-quality clean drinking water to local residents, priced at 20 to 30 percent the cost of bottled water. Pharmagen's



initiative is still in its early stages (it has 17 outlets in Lahore thus far), but the model shows promise in providing clean water access for Pakistan's low-income urban population.

Innovative and entrepreneurial models could also be explored in education and healthcare, where a large percentage of the urban population is already served by private enterprises. Successful models along these lines are currently being developed in other countries.

### KEY FACTORS TO CONSIDER

In exploring and developing entrepreneurial approaches to serve the urban poor in Pakistan, it is important to be cognizant of a few key factors. First, it is critical to build a deep understanding of low-income markets as a customer base and to develop affordable products/services and business models tailored to these markets, in the same way companies would do with upper and middle income groups. A very obvious concern here is that of affordability. Given the limited purchasing power of low-income groups, any product/service innovation will need to involve major cost reductions without compromising quality—so that there is both affordability for the customer and financial viability for the provider. Additionally, the service offering needs to be easy to use and access. Trust-building is equally important, given that entrepreneurs will be dealing with a customer base that has often been disappointed by public sector programs and defrauded by informal service providers.

Second, pioneering business models are charting new markets and territory, developing new value chains, and operating in weak business ecosystems and hostile regulatory environments. Therefore, the path to building up a large-scale and profitable business is volatile and slow, with a high risk of failure. These models require constant experimentation and iteration—as well as large doses of

perseverance—if they are to succeed.

Third, while entrepreneurial models hold the potential and promise to improve the quality of life of millions of low-income urban households in Pakistan over the long-term, it is important to remember that such models—and the private sector in general—are not substitutes for government. As mentioned earlier, government needs to remain the central actor in the delivery of public services, including to the poor. The key lies in determining where the private sector can play a support and complementary role to that of government.

### RECOMMENDATIONS

Here are some general recommendations to help enable entrepreneurial approaches and to facilitate the development of market-based models to serve Pakistan's urban poor.

#### **Provide flexible and patient capital to help build early-stage pioneering models.**

The biggest challenge that pioneering enterprises face is a lack of appropriate capital, which has impeded their growth. Because they are developing new models for serving the urban poor and working in challenging conditions, they need access to patient and flexible financing that gives them the space to experiment and develop their models while maintaining business discipline. Patient capital funds—that is, financing that provides equity and debt (combined with strategic grants) on flexible terms, and for longer durations and with a greater risk threshold than what is typically offered by more traditional private funding—can be a powerful catalyst for building pioneering business models serving the urban poor. Such funds can be set up by institutional donors, private foundations, and/or government.

#### **Leverage bank financing for growth and expansion.**

As enterprises move into a more mature phase of development—that is, when they have proved their business models, attained profitability, and demonstrated their readiness for expansion—they will need

additional financing to fuel their scale-up. One source of such growth financing is Pakistan's banks, which can be encouraged to finance these growth-stage enterprises through risk-sharing support such as guaranty facilities. Such risk-sharing support could be provided again by government or by institutional donors.

### **Establish urban innovation labs and incubators.**

Alongside appropriate financing, there is a need for urban innovation labs and incubators across different cities. These would enable new ideas and models to be developed and tested. There is lots of interest among Pakistan's educated youth and younger generation to tackle the nation's development challenges. Urban incubators—facilities where first-time young entrepreneurs testing business ideas for serving urban low-income groups can get mentoring, business training, and some seed capital—can provide young Pakistanis with the impetus to address this goal.

**Learn from other countries.** Pakistani entrepreneurs, policymakers, and other stakeholders can learn from experiences in other countries where entrepreneurial models are being developed to serve low-income urban populations. As mentioned earlier, India has seen very promising private sector innovation that provides housing and housing finance to lower income urban households making between \$200 and \$400 per month. Other models being pioneered in South Asia and in Africa include the delivery of water and sanitation, along with high-quality health and educational services, to low-income communities and urban slums. Many of these innovations could be relevant in the Pakistani context. Some business models could be directly replicated, while others could spark new ideas for other innovative models that serve the urban poor.

**Offer consumer financing to enable greater affordability.** In some cases—such as with housing purchases or improvements and

extensions—there will be a need to provide financing to low-income households to ensure that capital-intensive products are affordable to them. Select microfinance institutions and banks—which have both the inclination and capability to serve lower-income segments—could be encouraged to provide such financing through risk-sharing support such as loan guarantees.

### **Emphasize the strategic use of subsidies to enable access for the lowest income groups.**

Despite their promise, market-based models are unlikely to serve the poorest sections of the urban population (the bottom 20 to 25 percent). The extremely troubled socioeconomic situation of this demographic complicates its ability to access even the most affordable essential products and services through a purely market-based approach. In such situations, subsidies or outright aid must continue to be provided by government (as per its mandate) or by private philanthropy.

### **Simplify regulations to reduce the cost of business.**

Government policy in general should be geared toward reducing bottlenecks to setting up businesses and fostering entrepreneurship, both of which are engines for job creation and product/service delivery. Specifically, governments should remove unnecessary red tape and regulatory hurdles that prevent the launch and growth of enterprises that serve the urban poor. Affordable housing in particular is an area where, despite need and demand, it is incredibly difficult for developers not to get caught up in the web of corruption and red tape associated with the housing sector.

### **Provide tax incentives to traditional private business.**

Government policy could also offer tax breaks to businesses that specifically serve low-income groups in Pakistan. While this may not be politically feasible today given Pakistan's limited tax base, there is precedent for this in Pakistan's microfinance industry. Here, new

microfinance banks have been given an income tax holiday for the first five years of their operations so long as they pledge not to declare dividends. A tax-friendly environment can stimulate entrepreneurship geared at serving the urban poor, and particularly within the mainstream private sector—which tends to seek investments with clear tax and financial benefits.

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*This policy brief marks the last in a series of four on Pakistan's urbanization. Other briefs in the series can be accessed from the Asia Program webpage at <http://www.wilsoncenter.org/publication-series/pakistans-urbanization-policy-brief-series>*