IGC International Growth Centre

# Reforming the Urban Property Tax in Pakistan's Punjab

**May 2011**

## 1. Background

Property tax collection in the Punjab is roughly a fifth of the level of comparable countries both in terms of the proportion of total local revenues and as share of GDP. It is estimated that with comprehensive reform, property tax revenue for Punjab can increase to almost 25 billion[1]. This would be ten times compared to what is collected today, amounting to 13% of Punjab's development budget and 26% of its health and education budget for FY10.

Performance of the property tax in the Punjab has to be seen in the context of overall poor tax collection in the country. With tax-to-GDP ratio at 10.9% in FY10 (down from 12.5% in 1996), Pakistan fairs poorly in comparison with other South-Asian countries (Sri Lanka: 16.5% and India: 14%) and the average for developing countries (15%). Provinces account for a small fraction of the national tax revenue (4.3% of total national tax revenue or 0.5% of GDP). This profile has changed little in the past decade despite an increasing share of provinces in total national expenditure (see Table 1).

**Table 1: Overall Revenue Collection in Pakistan (share of GDP)**

| FY | Total Revenue | Tax Revenue | Federal Tax Revenue | FBR Revenue | Surcharges | Provincial Tax Revenue |
|---|---|---|---|---|---|---|
| 1999-00 | 13.4 | 10.6 | 10.1 | 9.1 | 1.0 | 0.5 |
| 2000-01 | 13.2 | 10.5 | 10.1 | 9.3 | 0.7 | 0.5 |
| 2001-02 | 14.0 | 10.8 | 10.3 | 9.1 | 1.2 | 0.4 |
| 2002-03 | 14.8 | 11.4 | 11.0 | 9.4 | 1.4 | 0.4 |
| 2003-04 | 15.1 | 11.9 | 11.4 | 9.2 | 1.1 | 0.5 |
| 2004-05 | 14.3 | 10.6 | 10.1 | 9.1 | 0.4 | 0.5 |
| 2005-06 | 14.9 | 11.3 | 10.9 | 9.4 | 0.7 | 0.5 |
| 2006-07 | 15.6 | 10.9 | 10.5 | 9.7 | 0.7 | 0.4 |
| 2007-08 | 15.3 | 10.6 | 10.1 | 9.6 | 0.5 | 0.5 |
| 2008-09 | 14.5 | 9.5 | 13.5 | 9.1 | 1.0 | 0.4 |
| 2009-10 | 14.7[2] | 10.9 | 13.6 | 9.4 | 0.5 | 0.5 |

*Source: Economic Survey, 2010.*

[1] Based on estimations during discussions with the E&T Departments and consultations of the Punjab Chief Minister's taskforce on Property Tax reform.
[2] Revenue data for FY10 based on budget estimates.

**IGC Pakistan**, Lahore University of Management Sciences, Room 106, Main Academic Block, Opposite Sector U, DHA, Lahore, Pakistan

**For enquiries about the IGC Pakistan programme, please contact IGC In-country Economist Saad Gulzar: saad.gulzar@theigc.org. This policy brief is based on the Policy Note authored by Ijaz Nabi and Hina Sheikh for the IGC. The Note provides a discussion on efforts underway to reform urban property tax in Punjab, Pakistan.**

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Poor revenue effort by the provinces is, however, no longer tenable given the radical departure in expenditure assignments following the 18th Amendment of the constitution. Voters now see more clearly that the responsibility to deliver social and economic outcomes rests squarely with the provincial governments. Greater efficiency in expenditure will, of course, help but given the substantial gap between millennium development goals and actual outcomes, expenditure will have to be increased and greater provincial revenue effort will be essential.

## 2. What is the Punjab Urban Property Tax?

The Punjab Urban Immovable Property Tax (UIPT) is levied under the Property Tax Act of 1958. Although, following the Local Government Ordinance (LGO) 2001, UIPT has become a local government tax, in reality, it functions as a provincial tax subject to revenue sharing with City District Governments (CGDs)[3] and Tehsil Municipal Corporations (TMAs). This is on account of sub-provincial entities' poor capacity to implement the tax.

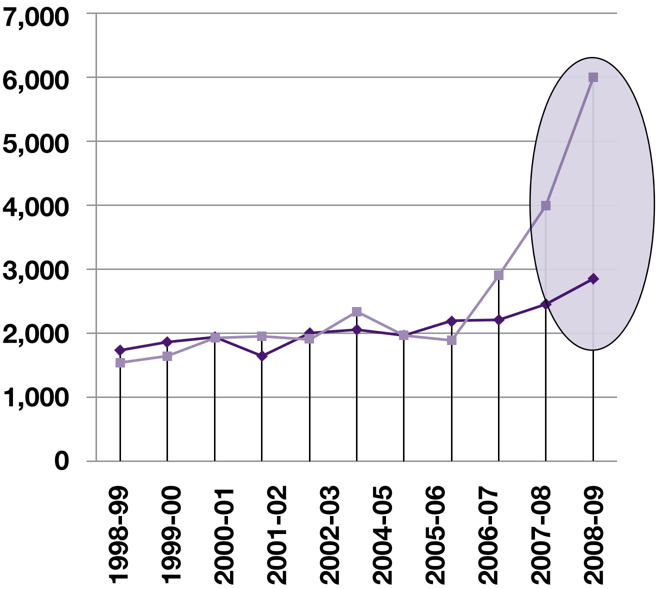
### Box 1: Key features of the Punjab UIPT

- The tax base consists of the combined Annual Rental Value (ARV) of land and building
- The tax base is assessed in a banded system according to provincially specified ARV tables
- All properties (unless specifically exempted ) are taxable
- Property tax in the Punjab is levied on a base of ARV at a flat rate of 20% on properties with an annual value of Rs 20,000 or less, otherwise a flat rate of 25% is applied
- There are three basic deductions viz.; the cost of furniture and repair and land tax paid
- There is a fair set of legal remedies, and appeals against valuation rolls are possible

## 3. Problems with the Punjab Urban Property Tax

Even though property taxation has a long tradition in the Punjab, the UIPT provides for only a small amount of revenue - as a share of the provincial GDP, UIPT is an abysmally low one tenth of 1%. The gap between targets and collections, reflecting problems of tax administration, has become worryingly large (see Figure 1).

**Figure 1: Property Tax Target vs Collection**




## 4. The main problems with Punjab's UIPT are:

**Valuation:** Despite the surge in market rents in the province between 2001 and 2008, the property tax base has not grown as valuation tables are not updated frequently enough to reflect actual market value. According to some estimates, for tax purposes, average property in the Punjab might be undervalued by almost 45%[4].

**Collections & Incentives:** World Bank (2006) has argued that strengthening tax administration and the billing and collection system can double if not quadruple revenue from the property tax. An IGC research project, in close cooperation with Department of Excise and Taxation, is currently underway that experiments with different incentive packages to motivate tax inspectors to increase collections.

**Exemptions:** Punjab's property tax structure is riddled with exemptions and preferential treatment of properties that have eroded the tax base. The most egregious is the preferential treatment of owner occupied property[5] that results in a loss of revenue equal to nearly a quarter of the current receipts.

**Poor Coverage:** Failure to notify new rating areas and extensions in existing rating areas have resulted in approximately 300,000 out of 750,000 properties remaining untaxed in Lahore alone (Bahl, Wallace, & Cyan, Pakistan: Provincial Government Taxation, 2008). A modest estimate

[3] Lahore, Faisalabad, Multan, Rawalpindi and Gujranwala
[4] (Bahl, Wallace, & Cyan, Pakistan: Provincial Government Taxation, 2008)
[5] Owner-occupiers pay 10% of the normal tax liability while reduction by the same percentage is allowed to provide for maintenance expenditures. Vacant properties are untaxed as are owner-occupied residential properties with a lot area less than 125 square yards

(two years old) is that approximately 73 more rating areas exist in the Punjab that need to be brought into the tax net.

**Tax Rates:** two issues related to tax rates are:

1. Property tax rates of 20% to 25% are considered too high, creating incentive for evasion.

2. The differential between rented out and owner-occupied properties in Punjab (1:10) is much higher than in Karachi (1:2) and in Islamabad Capital Territory (1:1). This means that in Punjab owner occupied properties pay a mere 10% of the tax levied on the same property if rented out. The differential in rates is argued to be the most important source of corruption in the Excise and Tax Department that results in a substantial leakage of revenue.

## 4. Getting the Property Tax Back on Track: Options for Reforms

The Government of Punjab has set a target of increasing revenue from urban property tax from the current 0.56% to at least 2.5% of the provincial budget over the next ten years under a phased approach. A task force on tax reform was announced by the Chief Minister of Punjab in 2008, which deliberated on all major sources of erosion of the property tax base and decided to focus, in the first phase, on reforming the system of valuations and the rate structure.

Although the task force's recommendations tackled other issues such as extending the coverage to include new rating areas, complete reform of current system of exemptions, strengthening tax administration and improving collections, core recommendations addressed issues of valuation and tax rates.

**Valuation:** The task force recommended that the interval between successive surveys/re-assessments be reduced from 5 years to 3 years and the Punjab UIPT Act, 1958 be amended accordingly via an ordinance. It was also recommended that annual indexation of tax demand with inflation should be conducted for each successive year till 2015. Table 2 shows an example (using Category A - Commercial[6]) of the revenue impact of updating the valuation table on rented and self-occupied property.

**Table 2: Revenue Impact of an Updated Valuation Table**

| Category A – Commercial | | | | |
|---|---|---|---|---|
| | Tax Rate: 20%-25% (Current) | | Tax Rate:10% (Recommended) | |
| Differential Options | Rented | Self | Rented | Self |
| Existing Valuation Tables @ Rs.12/- per sq yard/feet | | | | |
| 1:5 | Rs 8,100 | Rs 1,296 | Rs 8,100 | Rs 1,296 |
| New Valuation Table @ Rs.60/- per sq yard/feet | | | | |
| 1:5 | Rs 40,500 | Rs 8,100 | Rs 16,200 | Rs 3,240 |
| 1:2 | Rs 40,500 | Rs 20,250 | Rs 16,200 | Rs 8,100 |

Tax Rates: The task force tackled both issues of tax rates and differential between tax liability of self-occupied versus rented property. Various simulations were run to assess a) the impact on revenues and b) the impact on the tax payers. The task force recommended reducing the tax rate to 10% immediately while reducing the differential to zero in a phased manner achieving 1:1 parity by 2018. By applying the new valuations, reducing tax rate to 10% and the differential down to 1:5, the revenue demand jumps from the current Rs.2.8 billion to over Rs. 5.0 billion whereas complete elimination of the differential would result in revenue demand increasing nearly four times at over Rs. 8.0 billion. Detailed impact of these changes based on new valuations is summarized in Table 3 overleaf.

[6] Category A – Commercial applies to 1 marla shop with land area 25 sq yard and covered area 225 sq feet.untaxed as are owner-occupied residential properties with a lot area less than 125 square yards

**Table 3: Revenue Demand with New Valuations, Lower Tax Rate and Reduced Differential (Rs. Million)**

| | Residential | | | | Commercial | | | | Grand Total |
|---|---|---|---|---|---|---|---|---|---|
| | Diff | Self | Rented | Total | Diff | Self | Rented | Total | |
| **No. of Units** | | 383,001 | 186,717 | 569,718 | | 234,986 | 261,840 | 496,826 | 1,066,544 |
| **Existing Table Rate** | | 0.40-0.07 | 4.00 - 0.7 | | | 2.40-.32 | 12.00-1.6 | | |
| **Existing demand (@tax rate of 20-25%)** | 1:10 | 99 | 472 | 571 | 1:5 | 344 | 1,916 | 2,260 | 2,831 |
| **Proposed new Table Rate** | | 2.0 -0.20 | 10.0-1 | | | 12.00-1.20 | 60.00-6 | | |
| **Tax rate @10%** | | | | | | | | | |
| **Year 2011-14** | 1:5 | 153 | 401 | 554 | 1:5 | 636 | 3,832 | 4,468 | 5,022 |
| **Year 2014- 17** | 1:3 | 255 | 401 | 656 | 1:3 | 1,060 | 3,832 | 4,892 | 5,548 |
| **Year 2017-18** | 1:1 | 765 | 401 | 1,166 | 1:1 | 3,180 | 3,832 | 7,012 | 8,178 |

To assess the political viability of reform, the task force estimated the impact these changes would have on the tax payers. As in any reform process, some categories gain whereas others have an increase in the tax burden but the point to stress is that these increases are highly affordable. Table 4a and 4b show the changes in tax incidence in absolute as well as percentage terms for all seven categories of properties by status (residential/commercial and self-occupied/rented) respectively.

**Table 4a: Monthly Impact of Reform on Tax Payers (in Rs.)**

| | 10 Marla (1800 square feet) Residential | | | | I Marla (225 square feet ) Commercial | | | |
|---|---|---|---|---|---|---|---|---|
| | Self-occupied | | Rented | | Self occupied | | Rented | |
| | Existing tax | Tax after proposed reform | Existing tax | Tax after proposed reform | Existing tax | Tax after proposed reform | Existing tax | Tax after proposed reform |
| **A** | 148 | 369 | 1845 | 1845 | 108 | 270 | 675 | 1485 |
| **B** | 111 | 258 | 1384 | 1292 | 72 | 189 | 450 | 945 |
| **C** | 92 | 181 | 1153 | 904 | 63 | 132 | 315 | 662 |
| **D** | 74 | 127 | 923 | 633 | 45 | 93 | 225 | 463 |
| **E** | 55 | 89 | 692 | 443 | 36 | 65 | 180 | 324 |
| **F** | 44 | 62 | 554 | 310 | 29 | 45 | 144 | 227 |
| **G** | 33 | 44 | 332 | 218 | 23 | 32 | 113 | 159 |

*Existing tax = Old valuations, tax rate of 20-25%, differential ratio 1:10*

*Reform = New valuations, tax rate of 10%, differential ratio 1:5 (2011-14)*

**Table 4b: Impact of Reform on Tax Payers (% increase)**

| | 10 Marla (1800 square feet) Residential | | I Marla (225 square feet ) Commercial | |
|---|---|---|---|---|
| | Self-occupied | Rented | Self occupied | Rented |
| **A** | 150% | 0% | 150% | 120% |
| **B** | 133% | -7% | 163% | 110% |
| **C** | 96% | -22% | 110% | 110% |
| **D** | 71% | -31% | 106% | 106% |
| **F** | 60% | -36% | 80% | 80% |
| **G** | 40% | -44% | 57% | 57% |
| **H** | 31% | -34% | 41% | 41% |

*Existing tax = Old valuations, tax rate of 20-25%, differential ratio 1:10*

*Reform = New valuations, tax rate of 10%, differential ratio 1:5 (2011-14)*

Despite the low impact on household budgets, there is resistance to the proposed reforms by important players in the ruling PML-N[7]. Reform, however, is inescapable. Recent developments (the 7th NFC Award and passage of the 18th amendment to the constitution) have changed the landscape of fiscal arrangements in Pakistan. The federation's decision to increase fiscal transfers to the provinces reflects the realization that the provinces need to be held fully accountable for the services they deliver to the citizens and the overall investment climate they create for economic growth and employment. It is also clear, however, that the current resource envelope is insufficient to provide the needed services. Provinces will thus have to tap into under-explored sources of provincial revenue, including importantly the urban property tax. There is thus reason to be optimistic that a substantially reformed property tax yielding a healthy stream of revenues will eventually be implemented.

[7] This is the party in power in the Punjab, with aspirations of capturing the center in next elections.

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## Contact us

International Growth Centre
The London School of Economics and Political Science
4th Floor, Tower Two
Houghton Street
London WC2A 2AE
United Kingdom

General Office Tel: +44 (0)20 7955 6144

For enquiries about the IGC, please contact Adam Green:
a.r.green@lse.ac.uk
+44 (0)20 7955 3665

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