

## Urban property taxes in Pakistan's Punjab



### In brief:

- Property tax is a significantly under-utilised tax instrument in Punjab, accounting for only 6% of the total provincial tax. With a population of over 100 million, all of Punjab collects less urban property tax than the city of Chennai in India, home to about 10 million people.
- Punjab's cities have significant service delivery deficits. For example, only 35% of urban households in Punjab have piped water. These deficits will worsen in the absence of local financing that can be used to make public investments.
- This policy brief outlines the current landscape of property taxation in Punjab, highlights the significance of this source of public finance, and frames future policy direction, particularly the trade-offs between various valuation systems.

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## Introduction

Punjab has significant urban service delivery deficits:

- 4 in 10 urban households in Punjab don't have access to toilets connected to sewer systems;<sup>1</sup>
- Only 35% of urban households in Punjab have piped water;<sup>2</sup>
- 10% of urban households don't have access to handwashing facilities with water and soap.
- Punjab's urban housing deficit is estimated at 6.4 million housing units.<sup>3</sup>

Fixing this persistent service shortfall requires various systematic reforms, including raising more revenue to pay for public investment — land and property taxes provide a potentially significant revenue source to this end.<sup>4</sup>

Property taxes are used globally to finance delivery of urban services but in varying degrees. In the United States, about 17% of state and local revenue comes from taxing properties that finances key local services, although there is significant variation between states and municipalities.<sup>5</sup> In the United Kingdom, local councils rely principally on taxing residential properties to finance their delivery of services.<sup>6</sup> Across the OECD<sup>7</sup> countries, a group of largely high-income economies, property taxes are equivalent to about 2% of their GDP, in emerging markets it is about 0.6% while in low-income countries it is 0.3% of their GDP.<sup>8</sup> Pakistan lags far behind with property tax collection at less than 0.1% of its GDP.<sup>9</sup>

The importance of property taxes is intensified under Punjab's new decentralisation law, which came into effect in April 2019. While the law doesn't make changes to the urban tax regime, it does create new local governments with broader assigning of functions to deliver critical public services. This provides a critical policy juncture to strengthen Punjab's property tax infrastructure. With this background, the brief outlines Punjab's current property tax landscape and frames future policy conversation.

## Why are property taxes important for Punjab?

Property and land can offer a large, efficient, and long-term source of revenue for the province. This is due to the process of urbanisation, which increases productivity by bringing people and firms together in dense networks. This along with public investment pushes up the price of land and properties. As this process is continual rather than based on a specific event, such taxes can provide a long-term and significant source of revenue. With this cities can create a virtuous cycle: increased tax revenue from land and properties is directed to productivity-enhancing investments that further increase the value of land and properties that leads to more revenue. Figure 2 illustrates this.

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<sup>1</sup> Cooper, R. (2018). *Water, sanitation and hygiene services in Pakistan*. K4D Helpdesk Report. Brighton, UK: Institute of Development Studies.

<sup>2</sup> <https://www.wateraid.org/pk/sites/g/files/jkxooof326/files/WASH%20factsheet%20Punjab.pdf>

<sup>3</sup> Based on the underlying assumption that one household requires one housing unit. Source: <https://www.urbanunit.gov.pk/Upload/forest/11%20housing.pdf>

<sup>4</sup> Wani, S (2018) 'Reforming Pakistan's tax system: Evidence-based suggestions' International Growth Centre (IGC)

<sup>5</sup> Based on Lincoln Institute of Land Policy's Visualization Tool. <https://www.lincolninst.edu/research-data/data-toolkits/significant-features-property-tax/state-state-property-tax-glance/property-tax-data-visualization>

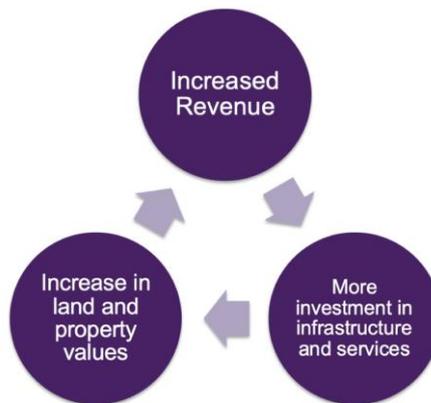
<sup>6</sup> The Taxation of Land and Property, Institute for Fiscal Studies.

<sup>7</sup> Organisation for Economic Co-operation and Development

<sup>8</sup> Birdsall, N., Sanjeev, G. (2018) 'On the Equity-Friendly Property Tax: Time for Developing Countries to Invest?'. Centre for Global Development.

<sup>9</sup> Summary of Consolidated Federal and Provincial Budgetary Operations of 2018-19 places this collection at Rs.7,026 million.

**Figure 2: Virtuous cycle**



Land taxes (that don't consider improvements on land) are more efficient than other taxes as the fixed supply of land cannot be altered in response to the tax. Hence, there is less likelihood of a reduction in economic welfare.<sup>10</sup> Property taxes, which take the value of construction into account of the tax liability, create perverse incentives for property-owners but evidence shows these are less harmful to investment and growth than other taxes such as income and corporate tax.<sup>11</sup>

Punjab is in an excellent position to capture the gains from urbanisation. Between 1998 and 2017, Punjab's five largest cities,<sup>12</sup> all with a population of more than a million people, grew their population by 60%.<sup>13</sup> This has been accompanied by an increase in land and property prices (as Figure 3 shows for Lahore), likely due to the process of urbanisation itself, but also through increased investment in real estate. Pakistan's real estate market has, as of 2017, an asset value of somewhere between \$400 and \$700 billion.<sup>14</sup>

**Figure 3: Surge in property values in Lahore, Pakistan (June 2013-June 2018)<sup>15</sup>**



More broadly, property taxes can play an instrumental role in financing Punjab's cities, and by extension, Pakistan's urban transition.<sup>16</sup> Presently, around 40% of Punjab's population resides in

<sup>10</sup> This is referred to as a deadweight loss of taxes in public economics.

<sup>11</sup> OECD (2010), *Tax Policy Reform and Economic Growth*, OECD Tax Policy Studies, No. 20, OECD Publishing, Paris

<sup>12</sup> Lahore, Rawalpindi, Faisalabad, Multan and Gujranwala.

<sup>13</sup> Javed, U. (2018). 'Punjab's urban challenge' *DAWN*

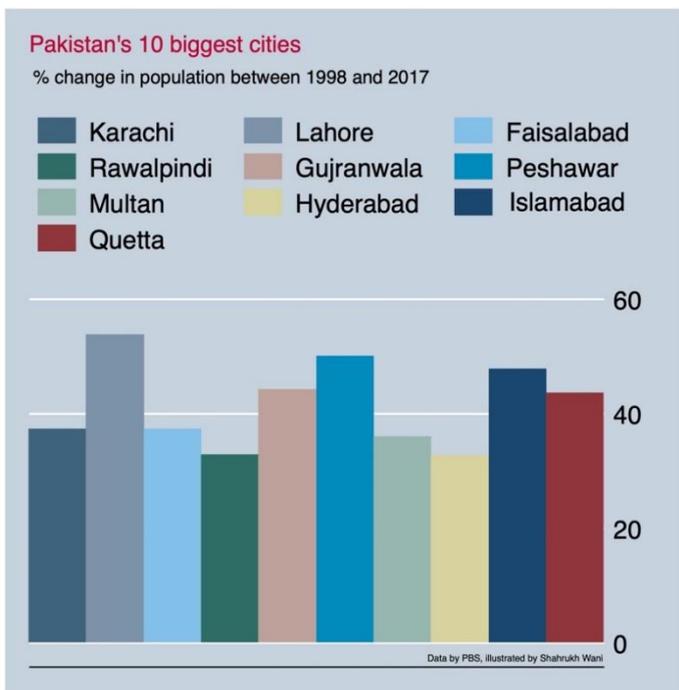
<sup>14</sup> Shaikh, H. (2019), 'The Precarious Housing Situation in Pakistan.' *Pakistan's Growth Story*

<sup>15</sup> Data is based on Zameen.pk online portal as adopted in the State Bank of Pakistan's 2019 *The State of Pakistan's Economy report*.

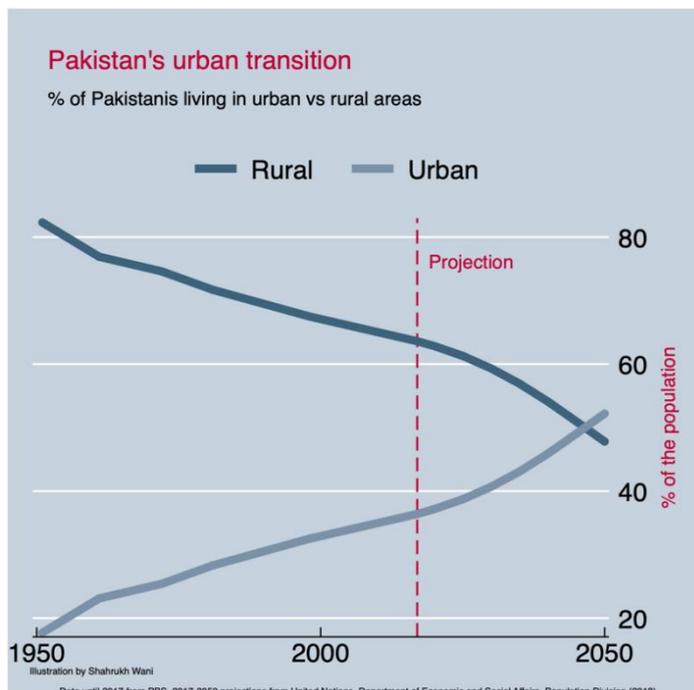
<sup>16</sup> Wani, S., *Pakistan's urban transition. DAWN.*

urban areas, projected to increase, both due to the natural growth in population and as more people move to cities. Figure 4 and 5 illustrate the expansion of Pakistan's urban growth.<sup>17</sup>

**Figure 4: Population change in 10 biggest cities**



**Figure 5: Pakistan's urban transition.**



## How do property taxes work in Punjab?

Since 1958, the Urban Immovable Property Tax (UIPT) is levied on both residential and commercial properties across Punjab.<sup>18</sup> According to law, the Punjab provincial government can both levy and collect the UIPT on behalf of local governments, while local governments have the power to set tax rates.

Presently, Punjab's Excise and Taxation Department charges 15% of the revenue as a collection charge. In theory, the remaining should be distributed to the local government that governs the locality where the tax is collected from. However, in practice, majority of this revenue is split among several provincially controlled agencies<sup>19</sup> providing urban services, and only a fraction ends up with the local governments. As a share of top sources for local government's own source revenue, property tax stood at 14% on average between 2010/11 to 2015/16. In principle, this undermines local accountability as the link between tax and service delivery becomes longer and complicated.

UIPT's liability is assessed on the annual rental value (ARV) of the property. This does not imply the property has to be rented out. The assessment is based on the presumptive value of the property if it were rented out, aided through a periodical survey of properties. Properties are assigned a value based on which cluster it falls under, which is further refined based on the exact location (such as larger properties near or on main-streets are valued at a higher rate, so are properties that are rented out, and those used for commercial purposes).

<sup>17</sup> Source: <https://www.theigc.org/publication/presentation-taxing-urban-land-and-property/>.

<sup>18</sup> Punjab Government also levies the Capital Value Tax (CVT) which is paid by the buyer at the time of buying property. Stamp Duty is a tax paid on the legal document at the time of purchasing property.

<sup>19</sup> In Lahore, this includes agencies such as the Water & Sanitation Agency (WASA).

The E&T Department conducts a house-to-house rental value assessment and subsequently publishes an ARV valuation table that splits tax liabilities across several clusters. There is, however, considerable lag between valuation drives undertaken by the department (the law requires this drive to happen every five years, but in practice there is a significant delay). Presently, the UIPT rate is set at 5% of the ARV.

Apart from the provincial government, the federal government also levies two kinds of property taxes, both at the point of sale to be paid by the seller.

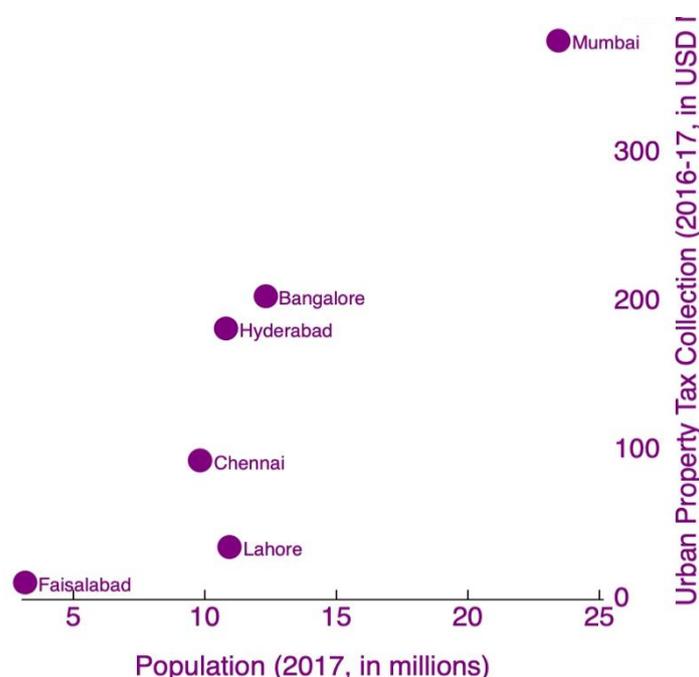
1. A 1.5% withholding tax at the time of the transaction of properties, adjusted in the annual income tax filed by the seller. As this is a withholding tax, it is collected by firms that act as a withholding agent and transferred to the federal government.
2. The second is a capital gains tax, also levied at the point of sale. The rate is time-bound and increases every year (for up to ten years) between when the owner buys the property and when he/she sells it.

Both these taxes are levied based on federal valuation tables calculated in an ad-hoc manner by the federal government and are considerably different from the provincial property valuation.

## How is the UIPT performing in Punjab?

**Figure 6 Urban Property Tax Collection in South Asia**

(Data: The World Bank and Punjab's E&T Department)



Punjab collects only a small fraction (6% in FY 2017-18) of the total provincial tax from this source.<sup>20</sup> All of Punjab, with a population of over 100 million, collects less urban property tax than the city of Chennai in India, home to about 10 million people (Figure 6).<sup>21</sup>

<sup>20</sup> Jamal, N (2018) Punjab property tax collection remains far behind. *DAWN*

<sup>21</sup> The World Bank and Punjab's E&T Department.

Several interconnected reasons contribute to the underperformance of UIPT:

1. ARV acts as an **imperfect proxy** for the value of the property due to a number of reasons. (1) by its very nature, rental value taxes properties on current and not the best possible usage of land, (2) As in Punjab rental value is assessed with a gap of at least 5 years, this lowers the taxes buoyancy by design, (3) in the application of ARV in Punjab, the value isn't based on market rates, but on a static measure of using presumptive survey based on type, use, size, location, and condition leading to under-valuation of properties (see Figure 7), (4), the formula of ARV, as applied in Punjab, is rigid, as it is set in law. This restricts the ability to change or improve upon the formula without a long legislative process so the government loses the instrument to alter the tax, and (5) in order for ARV to be a good proxy, it requires the rental market to be robust and broad. It is uncertain whether this is the case in Punjab.
2. UIPT has a radical **differential in tax rate** between owner-occupied and rented properties. With a ratio of 1:5 rented properties are taxed significantly higher than owner-occupied, creating an incentive for owners to not declare the rental status of the property.
3. There is a **high exemption floor** — plots up to 151 sq. yard (including those occupying key central locations) are exempt from taxes irrespective of their value.
4. There is often a **long time-lag** between when new properties are added and existing ones re-evaluated. This is compounded by the fact that the tax can only be levied at notified rating areas which may not necessarily cover the entire urban built environment.
5. There are significant **enforcement constraints** which extend to other types of taxes also face (such as agricultural tax) that restrict the ability of tax officials to seize property and levy a fine on tax evaders. Tax enforcement is often selective and politically motivated.<sup>22</sup> In many cases, tax evaders can push high administrative costs on the department by starting a lengthy judicial process.<sup>23</sup>

The Punjab government has proposed significant changes in the finance bill 2019-20 pertaining to UIPT for mobilising additional revenues.<sup>24</sup> The bill proposes an extension in the property tax rating areas to bring in commercial and residential properties along highways and main roads, align rating areas with actual city boundaries and carry out a fresh survey of properties as well as update valuation tables. These, however, do not target the central reasons for why ARV acts as an imperfect proxy (as mentioned above).

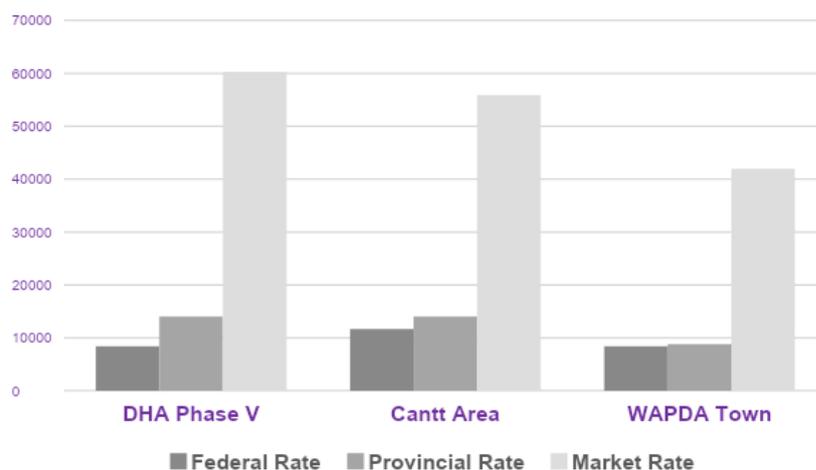
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<sup>22</sup> Piracha, M. M. (2016). *Sub-national government taxation: case of property taxes in Punjab, Pakistan* (Doctoral dissertation, University of Sussex).

<sup>23</sup> Piracha, M. M. (2016). *Sub-national government taxation: case of property taxes in Punjab, Pakistan* (Doctoral dissertation, University of Sussex).

<sup>24</sup> Jamal, N. (2019) Punjab's new tax measures to yield extra Rs11bn. *DAWN*

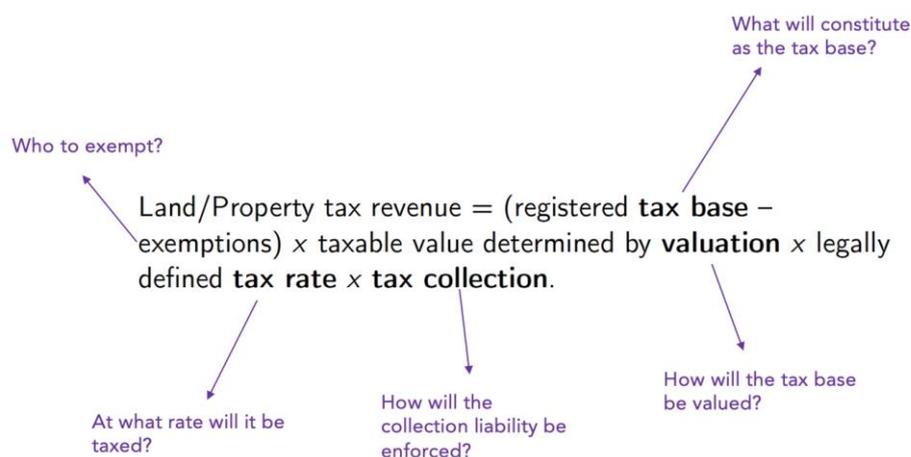
**Figure 7: Difference between federal, provincial valuation and market rate in Lahore (Sept 2018)** <sup>25</sup>



## Framing future policy directions

Policymakers have several considerations when levying land and or property taxes. Figure 8 summarises these policy questions.

**Figure 8: Main considerations for land/property tax policy** <sup>26</sup>



This brief focuses on two important policy concerns when framing future policy conversation around Punjab's property taxation. First is the distinction between rental, capital, and land value, and the second between recurrent and transaction-based property taxes. Both these set of distinctions are important in determine the kind of property tax regime best suited for Punjab.

- **Capital Value tax** is referred to taxing the value of land and the improvements, such as construction, built over time on land based on the market-rate.<sup>27</sup> They provide the closest

<sup>25</sup> Federal rates used by FBR also called FBR rates while provincial rates are known as DC rates.

<sup>26</sup> Wani, S (2020). Taxing Land and Property for urban service delivery in Pakistan. *IGC Presentation at the Federal Board of Revenue*.

<sup>27</sup> McCluskey, W.J.M.W.J., 2008. Rental Value versus Capital Value: Rental Value versus Capital Value: Alternative Bases for the Property Tax.

estimate to the actual value of the asset held but require a vibrant real estate market to generate data and keep up-to-date data on contents and characteristics of properties. This is hard to achieve within Punjab's context.

- Under the **area-based value**, property is taxed based on its surface area and/or location, typically as defined via a fixed rate per unit of land and/or structure. This includes no coefficients related to exact nature of build structure, such as the quality of structure. Hence, they do not require land and property transaction data or data on the contents and characteristics of properties, hence making it incredibly simple but valuations are unlikely to capture the true value of the property.
- **Rental value tax** is referred to the revenue the property can generate in the rental market, over a period of time. Data may be easier to obtain if high proportion of properties are rented and the rent is buoyant, i.e. changes to reflect economic circumstances. However, this is not the case in Punjab where rental market is very hard to get. It also typically reflects present rather than the best use of property and this could induce inefficient market behavior.
- A **hybrid points-based system** assigns a standard number of points to buildings based on their surface area. It then adds or deducts points for positive or negative property characteristics, such as its exact location in comparison to the main street, number of floors, the neighbourhood. In this way, it combines area and capital-based valuation. Doing so creates a more accurate assessment of the value of the property than an area-based model. While within each cluster, Punjab's tax system takes into account properties type, use, size, location, and condition but applies it onto an rental value tax model, rather than capital value. So, instead of looking at the market value of the property based on these characteristics, it looks at the rental value.

**Table 1: Trade-offs between various of valuation systems<sup>28</sup>**

Type of assessment	Accuracy	Data requirements on transactions	Data requirements on land contents/ characteristics	Estimation capacity required	Transparency
Capital Value Tax	High – though requires regular reassessments	Significant (on assets transactions)	High for greater accuracy	Significant	Can be low
Rental Value	High (where rental values are available and rent controls are not applied)	Significant (on rental transactions)	High for greater accuracy	Significant	Can be low
Points-based system	Medium (depending on calibration to market values and number of proxies included)	None needed – though helps in accuracy	Depends on number of proxies	Medium	Relatively high
Area-based	Low	None	Very limited.	Limited	High

A significant policy concern for property taxation in Punjab is deciding the appropriate valuation method that allows tax buoyancy (hence captures rising property value), generates considerable revenue, and demonstrates distributional fairness but is also feasible. Hence, policymakers in Punjab

<sup>28</sup> Adopted from Collier, P., Glaeser, E., Venables, A., Manwaring, P., and Blake, M. (2018) Land and property taxes for municipal finance – version 2. IGC Cities that Work Policy Paper.

can carefully consider the trade-offs between various valuation methods: moving to the capital value system would capture part of the increase in property value that results from public investment. For example, Mumbai's tax collection increased by 170% after shifting to capital value-based tax.<sup>29</sup> But, it is more complex as it needs comprehensive data. An alternative could be to use a much simpler point-based system that can capture much higher revenue while using simpler, easily identifiable property characteristics that are coupled with area-based assessments. For example, Freetown has announced this hybrid-based system based on a survey of visible property characteristics that is expected to push property tax revenue as much as five-fold. Punjab's current rental value system would benefit from moving towards the direction of a capital-value, perhaps by first adopting a more hybrid model.<sup>30</sup>

Another linked dimension is the distinction is between recurrent and transaction-based property taxes. In Punjab, the federal government's withholding and capital gains tax, along with the stamp duty, is a form of the latter, while the UIPT is a type of the former.

Recurrent property taxes are more efficient because taxes on property transfer are similar to other consumption taxes in that they reduce or distort the market for consumption or transfer. Because individuals have to pay more for something, they do it less (deadweight loss of taxes). Evidence from Toronto suggests that a 1.1% transaction tax leads to a 15% decline in the number of property sales.<sup>31</sup> This can reduce turnover of property and distort the allocation of land and property away from its more efficient use. In growing cities, such as in Punjab, land and property should ideally be reallocated as quickly and easily as possible. It should be able to change hands to its most efficient use.<sup>32</sup> A tax, like the current federal tax, that inhibits this movement restricts efficient use of land. In contrast, recurrent taxes on immovable property are designed to do the exact opposite. Property taxes, like UIPT in Punjab, can create incentives for landowners to use their land more productively. They encourage reallocation of property and are broadly progressive. The burden of this tax can be designed to be born predominantly by middle and high-income earners who tend to own properties.

However, because of this key benefit, it also faces a fundamental challenge - it can be politically challenging to implement. Elites are often the ones that stand most to lose financially. Because this tax is on the stock of assets, rather than income flows, it can also place constraints on asset rich but cash poor people, such as pensionaires. This explains to a large extent why property taxes are unexploited despite its widely acknowledged potential. Yet, if constructed correctly, it can help build political accountability. Lagos's Governor Fashola implemented property taxes successfully to deliver public services and got re-elected in 2011. Public investment led to increased property values, which in turn led to shared financial benefits resulting in further public investment. Once citizens see and feel the benefits of this virtuous circle, they buy-in and in this way, property taxes act as a beneficial tax system where property taxes can be clearly linked to corresponding benefits provided to taxpayers.<sup>33</sup> Careful design can also mitigate concerns around taxpayer liquidity: such as tax deferral schemes that allow taxpayers to defer payments until they sell the property or someone inherits it; or outright exemptions for pensionaires.

Recurrent property taxes on land is also the least distortive tax instrument in terms of negating GDP

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<sup>29</sup> Cheema, A. & Abbas, A. Property Taxation in KP: Reforms for an Efficient, Effective and Equitable Tax Policy.

<sup>30</sup> On the request of the Resource Mobilization Committee (RMC) chaired by Punjab's Finance Minister and to guide Punjab's reform agenda a team of IGC researchers are running simulations to assess the comparative advantage of the existing ARV system relative to an area-based CV system for Lahore and Sargodha.

<sup>31</sup> Dachis, B., Duranton, G. and Turner, M.A., 2012. The effects of land transfer taxes on real estate markets: evidence from a natural experiment in Toronto. *Journal of Economic Geography*, 12(2), pp.327-354.

<sup>32</sup> Norregaard, M.J., 2013. *Taxing immovable property revenue potential and implementation challenges* (No. 13-129). International Monetary Fund.

<sup>33</sup> Ahmad, E., Brosio, G. and Pöschl, C., 2014. Local Property Taxation and Benefits in Developing Countries—Overcoming political resistance. *Handbook of Multilevel Finance*.

growth.<sup>34</sup> This is followed by consumption (and transfer) tax, income tax and finally corporate income tax. Recurrent land tax also encourages re-allocation of capital to a better use: rather than continue living on land excessive to their needs, individuals may move out and property use change.<sup>35</sup>

With increasing pressure on local government finances, there is greater incentive to overcome the obstacles and disincentives that prevent property tax from working to its full potential. In consequence of all these factors, shifting the tax burden from the more distortive and inefficient property transfer taxes to recurrent taxes on immovable property represents a potential growth-orientated reform for Punjab. For the citizens of Punjab, the financial difference will be negligible. For the cities of Punjab, the economic potential will be huge.

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<sup>34</sup> Johansson, O.Å., Heady, C., Arnold, J., Brys, B. and Vartia, L., 2008. *Tax and economic growth*" *Economics Department* (No. 620). Working Papers.

<sup>35</sup> Clements, M.B.J., de Mooij, R.A., Gupta, M.S. and Keen, M.M., 2015. *Inequality and fiscal policy*. International Monetary Fund.